Accounting Practices and Procedures Manual
As of March 2011

Volume III
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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.
How to Use 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.
... 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>
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<td><a href="mailto:SVOinquirydesk@naic.org">SVOinquirydesk@naic.org</a></td>
</tr>
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<td>Annual Statement Reporting &amp; Statutory Accounting</td>
<td>(816) 783-8400</td>
<td></td>
</tr>
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</table>
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

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<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 | Superseded SSAP No. 99 |
| 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

| Section | Description |
| SSAP No. 9 | Revisions reject ASU 2010-09 as not applicable for statutory accounting. |
| SSAP No. 10R | Nonsubstantive revisions extended the SSAP No. 10R sunset clause through 2011 and incorporated additional disclosures for tax-planning strategies. |
| SSAP No. 17 | Revisions reject FAS 86 and EITF 96-14 due to new guidance included in SSAP No. 16R. |
| SSAP No. 25 | Revisions update the disclosure requirements to correspond with SSAP No. 5R. |
| SSAP No. 43R | Clarified AVR and IMR guidance in SSAP No. 43R to mirror the intent communicated in the SSAP No. 43R Question and Answer Implementation Guide. |
| SSAP No. 43R | Revisions clarify the definitions of loan-backed and structured securities. |
| SSAP Nos. 51, 52 & 61 | Revisions expand the disclosure revisions for annuity actuarial reserves and deposit liabilities by withdrawal characteristics. |
| SSAP No. 52 | Revisions incorporate an annual statement disclosure on retained assets. |
| SSAP No. 86 | Revisions to paragraphs 21(e) and 55 of SSAP No. 86 to mirror GAAP terminology and incorporate guidance adopted from the ASU 2010-08. |
| SSAP No. 87 | 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. |
| SSAP No. 90 | 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. |
| SSAP No. 100 | 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.” |
## 3. Revisions to the Appendices

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<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>
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<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>
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<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>
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<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>
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<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>
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<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>
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<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>
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**Statements of Statutory Accounting Principles (SSAP) - Volume I**

*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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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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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. 72

Statutory Surplus

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for capital stock, paid-in or contributed surplus and organizational surplus, and unassigned surplus is provided in Chapter 23, Capital Stock, Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, and Chapter 25, Unassigned Funds (Surplus) of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) and in Chapter 26, Capital Stock, Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus and Chapter 28, Unassigned Funds (Surplus) of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual).

2. GAAP does not provide specific guidance on surplus but rather provides guidance on shareholders’ equity which encompasses capital stock, additional paid in capital and retained earnings. The AICPA Audit and Accounting Guide: Stock Life Insurance Companies (AICPA Life Audit and Accounting Guide) and the AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies (AICPA P&C Audit and Accounting Guide) contain several references to surplus, however, they do not provide specific guidance on surplus.

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

SUMMARY CONCLUSION

4. Statutory surplus of a reporting entity consists of the following:
   a. capital stock;
   b. treasury stock;
   c. gross paid-in and contributed surplus;
   d. surplus notes;
   e. unassigned funds (surplus);
   f. special surplus funds;
   g. other than special surplus funds;

Capital Stock

5. The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share. The capital stock account represents the number of shares issued times the par value
of each share. When no par value is set forth, the reporting entity shall declare a “stated value” and record such amount in the capital stock account. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus.

6. Notes or other receivables received for the issuance of capital stock satisfied by receipt of cash or readily marketable securities prior to the filing of the annual statement shall be treated as a Type I subsequent event in accordance with Issue Paper No. 9—Subsequent Events (Issue Paper No. 9) and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

**Treasury Stock**

7. Treasury stock is capital stock that has been issued and subsequently reacquired by the reporting entity. It is held for either reissuance or cancellation in the future. When a reporting entity’s stock is acquired for purposes other than retirement, or when ultimate disposition has not yet been decided, the cost of acquired stock shall be reported as treasury stock which reduces statutory surplus. The acquisition of treasury stock has no effect on either the number of shares issued or the amount of paid up capital shown in the capital stock account. Cancellation of treasury stock shall reduce the capital stock account by the par value or stated value and reduce paid-in or contributed surplus by the excess of cost over par value or stated value.

**Gross Paid-in and Contributed Surplus**

8. Gross paid-in and contributed surplus is the amount of capital received in excess of the par value of the stock issued. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Forgiveness of a reporting entity’s obligations to its parent or other stockholders shall be accounted for as contributed surplus.

9. Notes or other receivables received as additional capital contributions satisfied by receipt of cash or readily marketable securities prior to the filing of the annual statement shall be treated as a Type I subsequent event in accordance with Issue Paper No. 9 and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

10. Real estate or other assets received as additional capital contributions are nonreciprocal transfers as defined in Issue Paper No. 73—Nonmonetary Transactions.

11. Stock purchase warrants issued in return for cash shall be credited to gross paid-in and contributed surplus. When debt instruments are issued with conversion features, no value shall be assigned to the conversion features unless the conversion feature is clearly separable from the debt obligation in the form of a detachable stock purchase warrant. In such instances the relative fair value of the detachable stock purchase warrant at time of issue shall be credited to gross paid-in and contributed surplus.

**Surplus Notes**

12. Surplus notes are financial instruments that are subject to strict control by the commissioner of the reporting entity’s state of domicile and have been approved by the commissioner as to form and content. These instruments are commonly referred to as surplus notes but are also referred to as surplus debentures or contribution certificates. Issue Paper No. 41—Surplus Notes (Issue Paper No. 41) provides the specific characteristics of surplus notes and provides accounting guidance for surplus notes. Only notes meeting the requirements of Issue Paper No. 41 shall be accounted for as surplus notes.
Unassigned Funds (Surplus)

13. Unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. Certain components of unassigned funds (surplus) are addressed in more detail in other issue papers. Unassigned funds (surplus) is comprised of:

a. Net Income
Net income resulting from insurance and other operating activities of the reporting entity since its inception.

b. Unrealized Capital Gains and Losses on Investments
The cumulative unrealized capital gain or loss that results from differences between the prescribed statement value of investments carried at market value and the cost of those investments is a component of unassigned funds (surplus). This component changes as periodic unrealized gains and losses are credited or charged directly to unassigned funds (surplus).

c. Effect of Exchange Rate Fluctuations
The cumulative gain or loss due to translating foreign operations to U.S. dollars and changes in balance sheet asset and liability values due to foreign currency translation are recorded as unrealized capital gains and losses and therefore are a component of unassigned funds (surplus). This component changes as the exchange rates fluctuate.

d. Nonadmitted Assets
The nonadmitted values of assets owned by a reporting entity are a reduction of unassigned funds (surplus). This component of unassigned funds (surplus) changes as nonadmitted asset values change. Changes in nonadmitted asset values are charged or credited directly to unassigned funds (surplus).

e. Provision for Reinsurance
A reporting entity must establish a statutory liability, provision for reinsurance, for unsecured reinsurance recoverables from unauthorized reinsurers and certain overdue balances from authorized reinsurers. The liability is charged directly to unassigned funds (surplus). Therefore, at any point in time there is a reduction of unassigned funds (surplus) equal to a reporting entity’s liability for unauthorized reinsurance.

f. Asset Valuation Reserves
Where an Asset Valuation Reserve is required to be recorded as a statutory liability, there is a reduction of unassigned funds (surplus) in an amount equal to the liability. Changes to the Asset Valuation Reserve are charged or credited directly to unassigned funds (surplus).

g. Separate Accounts
A life insurer’s balance sheet includes the total assets and liabilities of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Changes in the surplus of the separate accounts business of an insurer are charged or credited directly to unassigned funds (surplus).

h. Subscribers Savings Accounts
Subscribers Savings Accounts (SSA) are unique to reciprocals. SSAs represent a portion of a reciprocal insurance company’s surplus that has been identified as subscribers (policyholders) accounts. When the source of amounts credited to the subscriber accounts is from the reciprocal’s operations, the amounts are reported as unassigned funds (surplus).
i. **Dividends to Stockholders**
Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair market value of the assets distributed if it is property dividend, or the par value of the company’s stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of Issue Paper No. 25—*Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

j. **Change in Accounting Principles**
The effects of a change in accounting principle or the application of an accounting principle, such as a change in reserve account because of a change in valuation basis, are reported as a charge or credit to unassigned funds (surplus). The effect of these changes shall not be included in the determination of net income or loss.

k. **Correction of an Error**
Corrections of errors in previously reported financial statements are charged or credited directly to unassigned funds (surplus). The effect of corrections of errors shall not be included in the determination of net income or loss.

l. **Stock Issuance Expenses**
Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees are charged to unassigned funds (surplus).

m. **Change in Surplus as a Result of Reinsurance**
Life and accident and health insurers report increases in surplus that result from certain types of reinsurance transactions on a net of tax basis. As profits emerge from the ceded business the increase in surplus is amortized to income as described in paragraph 39.

n. **Changes in Deferred Tax Assets and Deferred Tax Liabilities**
Consistent with the conclusions reached in *Issue Paper No. 83—Accounting for Income Taxes*, changes in deferred tax assets and deferred tax liabilities, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of unassigned funds (surplus).

o. **Other**
This category includes other gains and losses in surplus not specifically identified elsewhere in this issue paper including but not limited to; net proceeds from life insurance on employees and unearned compensation relating to stock issuances made under compensatory Employee Stock Ownership Plans, Stock Option Plans and Stock Purchase Plans.

**Special Surplus Funds**
14. A reporting entity may establish a segregated surplus account to provide for contingencies. Surplus thus appropriated is called appropriated surplus or special surplus funds. Surplus resulting from any retroactive reinsurance transaction entered by a property and casualty insurer must be recorded as an appropriation of surplus by the ceding company (special surplus from retroactive reinsurance account). Voluntary and general contingency reserves which are not actual liabilities of the reporting entity are shown as appropriated surplus or special surplus funds.
Other Than Special Surplus Funds
15. Amounts provided to reporting entities, other than stock companies, in the organization stage to defray the expenses and meet initial minimum surplus requirements required to obtain a license to do the business of insurance shall be reported as a separate component of surplus called Other Than Special Surplus Funds. Examples of these types of deposits include but are not limited to: guaranty fund notes, contribution certificates, and subscriber accounts that represent individual subscriber contributions.

Changes in Statutory Surplus
16. The components of the change in the capital and surplus accounts shall be presented for each year for which an income statement is presented.

Disclosure
17. The financial statements shall disclose the following items:

   a. the number of shares of each class of capital stock authorized, issued and outstanding as of the balance sheet date and the par value or stated value of each class;

   b. the dividend rate, liquidation value and redemption schedule (including prices and dates) of any preferred stock issues;

   c. dividend restrictions, if any, and an indication if the dividends are cumulative;

   d. the portion of the profits that may be paid as ordinary dividends to stockholders;

   e. a description of any restrictions placed on the unassigned funds (surplus) funds including for whom the surplus is being held;

   f. for mutual reciprocals and similarly organized entities, the total amount of advances to surplus not repaid, if any;

   g. the total amount of stock held by the reporting entity, including stock of affiliated entities, for special purposes such as conversion of preferred stock, employee stock options and stock purchase warrants;

   h. a description of the reasons for changes in the balances of any special surplus funds from the prior period;

   i. the cumulative portion of unassigned funds (surplus) represented or reduced by each of the following items:

      i. unrealized gains and losses;
      ii. nonadmitted asset values;
      iii. separate account business;
      iv. asset valuation reserves;
      v. provision for reinsurance;

   j. For reciprocal insurance companies only:

      i. the amount of surplus identified as subscriber savings accounts;
      ii. the source of the funds (either from the reciprocal’s operations or contributed by the individual subscriber) and, the reporting location in surplus;
      iii. the conditions upon which the balances are paid to the subscribers;
DISCUSSION

18. The statutory accounting principles set forth in this issue paper adopt current statutory accounting guidance and are also consistent with the statutory guidance for surplus notes set forth in Issue Paper No. 41.

19. This issue paper is consistent with the requirements of the Annual Statement Instructions that the changes in the capital and surplus accounts be reflected for each year for which an income statement is presented. This is consistent with Accounting Principles Board Opinion No. 12, Omnibus Opinion - 1967 (APB 12) paragraphs 9 and 10. These paragraphs are adopted with modification to eliminate the option of disclosing changes in the notes to the financial statements rather than in the Statement of Capital and Surplus. This issue paper is consistent with the disclosure requirements of paragraphs 10 and 11 of Accounting Principles Board Opinion No. 10, Omnibus Opinion - 1966 (APB 10). Those provisions of APB 10 are adopted herein. This issue paper also adopts paragraph 28 of Accounting Principles Board Opinion No. 9, Reporting the Results of Operations and FASB Emerging Issues Task Force Issue No. 88-9, Put Warrants, with a modification to reject guidance related to earnings per share.

20. This issue paper expands current statutory accounting to require disclosure of the reasons for changes in the balance of special surplus funds and the components of unassigned funds (surplus) as of the date of the financial statements. This change was made to enhance comparability of financial statements. To the extent that disclosures required by this issue paper are made within specific notes, schedules, or exhibits to the financial statements, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by Annual Statement exhibits and schedules (e.g., annual audit reports) shall include all disclosures required by this issue paper.

21. This issue paper rejects FASB Emerging Issue Task Force Issue No. 85-1, Classifying Notes Received for Capital Stock (EITF 85-1), which generally requires notes received as capital contributions to be recorded as a debit to equity rather than as an asset. Paragraphs 6 and 9 of this issue paper require that such notes are recorded as admitted assets if they are satisfied by receipt of cash or readily marketable securities prior to the filing of the statement. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted. This issue paper also rejects FASB Emerging Issue Task Force Issue No. 85-2, Classification of Costs Incurred in a Takeover Defense and FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt.

22. This issue paper adopts paragraph 12 of Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins (APB 6) which provides accounting guidance for treasury stock transactions with modification to eliminate the option of recording treasury stock as an asset. Current statutory guidance is limited on recording transactions involving treasury stock. This issue paper rejects paragraphs 1 through 11 and paragraphs 13 through 24 of APB 6.

23. Current statutory accounting does not address stock purchase warrants. The conclusions reached in this issue paper are consistent with APB Opinion No. 14, Accounting for convertible Debt and Debt Issued with Stock Purchase Warrants (APB 14) which was adopted in Issue Paper No. 80. Disclosures regarding stock purchase warrants required by this issue paper are an expansion of current statutory guidance.
24. This issue paper rejects *Accounting Research Bulletin No. 43*, Chapter 1, *Prior Opinions* (ARB 43). The underlying concepts addressed by ARB 43, Chapter 1, are addressed within other relevant GAAP literature to the extent they are applicable.

25. Paragraph 14 of this issue paper addresses appropriated surplus and special surplus funds. This statutory accounting treatment is consistent with paragraph 15 of *FASB Statement No. 5, Accounting For Contingencies*, (FAS 5) and therefore paragraph 15 of FAS 5 is adopted herein.

26. The changes to current statutory accounting referred to in paragraphs 20 through 23 of this issue paper were made to provide guidance where current statutory is silent and practice may be diverse. Providing statutory guidance to be followed by all reporting entities meets the objective of the Statement of Concepts which states:

   **Consistency**

   The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

27. The statutory accounting principles set forth in this issue paper are also consistent with references to surplus found in the AICPA Life Audit and Accounting Guide and the AICPA P&C Audit and Accounting Guide. Although GAAP does not specifically address surplus, statutory surplus is not comparable to stockholders’ equity under GAAP. Stockholders’ equity is meant to be a measure of the net equity in a reporting entity held by the owners, while statutory surplus is meant to provide an indication of the excess of assets readily available to meet policyholder obligations over those obligations.

28. Several components of the surplus section of a reporting entity’s statutory balance sheet are also components of the stockholders’ equity section of the reporting entity’s GAAP balance sheet.

   a. Capital stock and treasury stock are treated consistently between statutory surplus and stockholders’ equity;

   b. Gross paid-in and contributed surplus for statutory reporting purposes is consistent with the accounting treatment afforded to additional paid in capital in a reporting entity’s stockholders’ equity under GAAP reporting.

29. As discussed in Issue Paper No. 41, GAAP treats surplus notes as liabilities and not as equity whereas Issue Paper No. 41 as well as current statutory guidance account for the notes as surplus.

30. Statutory accounting utilizes unassigned funds (surplus) to account for several additional components of policyholder surplus. These items include net income, unrealized gains and losses on investments and unrealized gains and losses resulting from exchange rate fluctuations, nonadmitted asset values, certain statutory liabilities such as the asset valuation reserve and the provision for reinsurance, the effects of changes in accounting principles and corrections of errors, appropriations of surplus, separate accounts, subscriber savings accounts, stock issuance expenses and dividends to stockholders.
31. GAAP requires some of the items in unassigned funds (surplus) to be reflected in retained earnings while others are reported as a separate and distinct component of stockholders’ equity. Those items that are accounted for as part of retained earnings include:

   a. net income;
   b. effect of changes in accounting principles;
   c. corrections of errors;
   d. dividends to stockholders.

GAAP distinguishes between stock dividends and stock splits for purposes of reclassifications between paid in capital and retained earnings although total stockholders’ equity is not affected. This issue paper adopts paragraphs 1 through 4 and 10 through 16 of Accounting Research Bulletin No. 43, Chapter 7B, Stock Dividends and Stock Split-ups.

32. Those items in unassigned funds (surplus) that are reported as separate and distinct components of stockholders’ equity under GAAP include:

   a. unrealized gain or loss on investments;
   b. unrealized gain or loss resulting from exchange rate fluctuations.

The amount of unrealized gains or losses on investments may differ between GAAP and statutory reporting because of the amounts at which investments are reported in the balance sheet under the different bases of accounting. Unrealized gains and losses relating to exchange rate fluctuations will differ as well because GAAP requires certain types of gains and losses relating to exchange rate fluctuations to be charged or credited to operations in the period of the change.

33. GAAP does not recognize statutory liabilities such as the provision for reinsurance or the asset valuation reserve and therefore those items are not components of stockholders’ equity whereas they are components of unassigned funds (surplus).

34. For GAAP, stock issuance expenses are accounted as a reduction of additional paid in capital whereas for statutory purposes they are accounted for as a reduction of unassigned funds (surplus).

Drafting Notes/Comments
- Issue Paper No. 3—Accounting Changes, provides guidance on reporting changes in accounting principles and corrections of errors.
- Issue Paper No. 84—Quasi-reorganizations, permits adjustments to surplus and capital accounts for the effects of a quasi-reorganization in limited situations.
- Issue Paper No. 41—Surplus Notes, provides the accounting and disclosure requirements for such instruments.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
35. Chapter 23, Capital Stock, of the P&C Accounting Practices and Procedures Manual provides the following guidance:

   The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share, and the number of shares to be issued and sold so as to provide at least the minimum paid-up capital.
Minimum Capital

Many states require that, upon the organization or admission of an insurance company, a minimum amount of paid-up capital must be established and maintained for that particular company at all future times. If capital exceeds the minimum required, some states may permit reductions of capital with the commissioner’s consent.

Minimum requirements may be based on the number of lines of business a company writes with a minimum amount for the first line and an additional amount for each line. Other states may require a fixed amount for a certain type of company. The requirements of any jurisdiction are intended, in accordance with sound business practices, to meet the needs of the proposed business.

Par Value Requirements

Traditionally, insurance companies have issued one class of stock, par value common stock, and many states have statutes or rules establishing the minimum par value per share.

In recent years, some states have begun permitting insurers to issue the same classes of stock as noninsurers. This includes issuing of common stock with no par value. The par value of a company’s common stock must be consistent with the statutes and regulations of the domiciliary state.

The statutes and regulations of some jurisdictions permit an insurer to issue preferred stock. They should be reviewed carefully prior to the issuance of any preferential shares.

Original Stock Sale

Most states have detailed regulations with regard to the original sale of a company’s stock. These regulations may include, but are not necessarily limited to, provisions relating to the following:

1. Organization permits and certificate of authority;
2. Registration of securities;
3. Form of subscription agreement and subscription requirements;
4. Promoter stock;
5. Consideration for shares;
6. Payment for shares;
7. Form of certificates representing shares;
8. Deposit and escrow requirements;
9. Fractional shares;
10. Liability of subscribers and shareholders for unpaid shares;
11. Shareholders’ pre-emptive rights;
12. Organization expenses and liability of incorporators.

Prior to any organization activity, any individual or group of individuals desiring to establish an insurance company should consult with the regulatory authority of the state in which it will be domiciled. Establishing an insurance company is a complex procedure and careful attention must be paid to the particular requirements of the state of domicile.
Subsequent Stock Issues

The statutes and regulations of the domiciliary state should be consulted prior to the offering or issuance of any stock.

Treasury Stock

Treasury stock is capital stock of the company that has been issued, fully paid for, and subsequently reacquired by the company. It is held for either reissuance or cancellation in the future.

An insurance company is customarily restricted in the amount of treasury stock it is authorized to hold, and in the reasons for holding such stock. The restrictions of some states permit an insurance company to own treasury stock only when the company’s net assets exceed the sum of its paid-up capital and its required surplus, after deducting the surplus attributable to unrealized appreciation in value or revaluation of the company’s assets, and any increase arising from the surrender of the company’s own shares.

Statutes and regulations of the various jurisdictions may vary. In some states, recently organized insurers may only acquire treasury stock with the permission of the state regulatory authority. Reporting requirements have also been promulgated. Statutes may provide that such acquisition be approved by the stockholders or by the board of directors, and require sufficient surplus to cover the acquisition. Some states permit acquisition of the company’s own shares without stockholder or board approval for the following purposes:

1. Redemption or purchase of its redeemable shares at a cost not to exceed the redemption price;
2. Elimination of fractional shares;
3. Collection or compromise of debt to the corporation;
4. Payment to dissenting stockholders entitled to payment for their shares.

The acquisition of treasury stock has no effect on either the number of shares issued or the amount of paid-up capital shown in the capital stock account. However, the use of treasury stock for the cancellation of capital stock does reduce the capital stock account. Treasury stock is reported as a reduction of surplus.


36. Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, of the P&C Accounting Practices and Procedures Manual provides the following guidance:

This chapter discusses paid-in or contributed surplus stock companies and organizational surplus for mutual companies, the amounts required upon incorporation, and the amounts to be maintained at all times.

Besides paid-in capital (common stock), stock insurance companies are required to have a minimum amount of initial paid-in surplus. Mutual companies, which, because of their corporate structure, do not issue capital stock are required to have a minimum amount of initial organizational surplus. Most states require companies to maintain a minimum amount of surplus.

Initial contributed or organizational surplus is obtained to provide both protection to the policyholders and the necessary working capital with which a company can pay the expense of commencing business. The minimum surplus a company must have and at all times maintain is customarily somewhat less than the initial amount required to obtain a certificate of authority.
While paid-in or organizational surplus will not be decreased (except upon a return of original investment), unassigned surplus deficits are subtracted from the amount of original surplus to determine if a company has fallen below the required minimum surplus.

Surplus, for purposes of meeting the minimum requirements, consists of:

- Paid-in or contributed surplus for stock companies;
- Guaranty fund surplus for mutual companies;
- Subordinated surplus debentures, notes, or similar instruments;
- Special or appropriated surplus;
- Unassigned surplus;
- Organizational surplus for mutual companies.

**Minimum Surplus Requirements - Stock Companies**

Most states require a minimum surplus at the time of organization. This amount, which is generally represented by paid-in surplus, may be determined by the nature of the company or by the number of lines a company writes. State statutes may further require a minimum surplus to be maintained permanently.

**Minimum Surplus Requirements - Mutual Companies**

Mutual companies, upon organization, are required to have an organizational surplus which usually conforms to the capital required of a stock company. In addition to this permanent surplus, an expendable surplus may also be required at the time of organization. Some states do not require a permanent surplus for a mutual company if the assessment liability of its members is unlimited. The statutes and regulations of the state of domicile should be consulted with regard to the appropriate requirements.

The funds necessary to meet initial surplus requirements will generally be generated either by applications for insurance or by contribution notes.

**Minimum Surplus Requirements - Reciprocals**

State statutes should be reviewed for surplus requirements of reciprocals, which are usually similar to the requirements for mutual companies.

**Capital or Surplus Impairment**

State statutes vary widely with regard to the impairment of capital or minimum surplus in a stock company or a permanent surplus in a mutual company. In most cases, an order or notice is issued requiring correction of the impairment. Correcting such an impairment may entail issuing new capital stock, surplus or contribution notes, subordinated debentures, or some other means such as a contribution to paid-in surplus. If time limitations are not met, further action will be taken.

Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus, of the Life/A&H Accounting Practices and Procedures Manual contains similar guidance.

37. Chapter 25, Unassigned Funds (Surplus), of the P&C Accounting Practices and Procedures Manual provides the following guidance:
Unassigned funds (surplus) is the undistributed and unappropriated amount of surplus and includes net income as well as the following items.

**Unrealized Capital Gains and Losses on Investments**

The annual statement includes a framework for calculating the unrealized capital gains and losses. Unrealized capital gains and losses result from a change in the prescribed statement value of investments between reporting dates. The change in the net unrealized capital gain or loss is a direct credit or charge to unassigned surplus.

**Change in Nonadmitted Assets**

The change in nonadmitted assets between the current and prior years statement is charged or credited directly to unassigned surplus. (See Chapter 9-Nonadmitted Assets.)

**Change in Liability for Unauthorized Reinsurance**

Where credit is not allowed for unauthorized reinsurance, the ceding insurer must establish a liability. Any change in the liability should be charged or credited directly to unassigned surplus. (See Chapter 22-Reinsurance.)

**Change in Foreign Exchange Adjustment**

Assets and liabilities in foreign currency are subject to adjustment to the prevailing foreign exchange rate. The change in the foreign exchange adjustment between the current and prior statement is charged or credited directly to unassigned surplus. (See Chapter 13-Other Liabilities.)

**Change in Excess of Statutory Reserves Over Statement Reserves**

Certain liability and compensation loss and loss expense reserves are subject to statutory minimums. The change in such statutory reserve between the current and prior years statement is charged or credited directly to unassigned surplus. (See Chapter 10-Losses.)

**Dividends to Stockholders**

Dividends to stockholders may only be paid from unassigned surplus. The amount available may be affected by numerous factors; for example, the insurance laws of the state of domicile, the existence of contractual commitment such as a borrowing agreement, etc. The corporation, as a matter of policy through its board of directors, may limit the amount of dividends and retain profits.

Dividends declared by the board are charged directly to unassigned surplus and are carried as a liability in the balance sheet until paid. The amount of the dividend is the actual amount paid in cash, the fair market value of the property, or the par value of the company’s stock. A stock dividend is recorded as a transfer from unassigned surplus to capital.

**Stock Issuance Expenses**

Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees, are chargeable to the unassigned surplus account and not to paid-in surplus.

**Appropriations of Surplus**

A company may establish a segregated surplus account to provide for contingencies. Surplus thus segregated is called appropriated surplus or special surplus funds. Voluntary and general contingency reserves which are not actual liabilities of the company should be shown as appropriated surplus or as special surplus funds. An appropriation of surplus is recorded as a transfer from unassigned surplus to special surplus funds.
Subscribers Savings Accounts

Subscribers Savings Accounts (SSA) represent a portion of a reciprocal insurance company’s surplus that has been identified as subscribers (policyholders) accounts. SSA is unique to reciprocals as the policyholders are also the owners of the company.

There are two sources for deposits to subscriber accounts. In the first, the individual subscriber may be the source of certain deposits to subscriber accounts, as some reciprocals may require subscriber contributions to join the reciprocal. In the second, the reciprocal is the source, by identifying as SSA a portion of its unassigned surplus generated from its operations. The source of SSA has a bearing on the proper financial statement presentation.

When the source of amounts credited to the subscriber accounts is the individual subscriber, these amounts should be reported in Other Than Special Surplus.

When the source of amounts credited to the subscriber accounts is from the reciprocals operations, it is appropriate to report these amounts as Unassigned Surplus. In this case, the individual subscriber accounts are merely an internal recordkeeping device and not an indicator of restrictions on the funds, or an obligation to pay these amounts to the subscribers. Reciprocal-generated funds that are identified as SSA are an integral part of the company’s operational surplus and are fully available to meet the obligations of the reciprocal. Therefore, when the source of SSA is the reciprocal, financial statement presentation should report SSA as part of the Unassigned Surplus. The Notes to Financial Statements should also disclose pertinent information concerning amounts identified as SSA and conditions of repayment. The amount of surplus from operations that is identified as SSA is generally at the determination of the management of the company and its Board of Directors.

SSA balances may be paid, depending upon domiciliary state law, to subscribers upon termination of their association with the company, regardless of the source of the SSA. In this instance, any unpaid amounts owed to terminated subscribers must be reported as a liability.

Also, if deemed prudent by the company management, periodic partial payments from SSA may be made to subscribers under certain predetermined situations. For example, distributions may be made to those subscribers whose account balances exceed an established threshold. If the company has declared that it will distribute a certain amount of its Unassigned Surplus identified as SSA, but has not actually distributed the amounts by the next reporting date then the company should decrease Unassigned Surplus by the amount approved and report the unpaid amount as a liability. Other than these instances, SSA is typically not owed to the subscribers, and should not be treated as a liability.

Chapter 28, Unassigned Funds (Surplus), of the Life/A&H Accounting Practices and Procedures Manual contains similar guidance.

38. The NAIC Annual Statement Instructions require the following disclosures regarding capital and surplus and policyholders’ dividend restrictions.

Instruction:
   a. Shareholders’ dividends - State terms of dividend restrictions, if any; indicate if dividends are cumulative and indicate what proportion of the profits of the company may be paid to stockholders.
   b. For each issue of preferred stock, indicate exact description of issue, dividend rate, par value, stated value and liquidation value. If the preferred stock is redeemable, indicate the redemption prices and dates.
   c. Unassigned surplus - Describe any restrictions which have been placed on the unassigned surplus funds. Indicate for whom the surplus is being held, and for mutual companies only, the total amount of advances to surplus not repaid, if any.
d. Indicate the total amount of stock held by the company, including stock of affiliated companies, for special purposes such as conversion of preferred stock and employee stock options.

39. Section 4 of the Life and Health Reinsurance Agreements Model Regulation provides the following guidance for ceded reinsurance:

C(1) Agreements entered into after the effective date of this regulation which involve the reinsurance of business issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding company with the commissioner within thirty (30) days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer's actuary who signs the financial statement actuarial opinion with respect to valuation of reserves shall consider this regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with this department. The actuary should maintain adequate documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.

C(2) Any increase in surplus net of federal income tax resulting from arrangements described in Subsection C(1) shall be identified separately on the insurer’s statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account, page 4 of the Annual Statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the “Reinsurance ceded” line, page 4 of the Annual Statement as earnings emerge from the business reinsured.

{For example, on the last day of calendar year N, company XYZ pays a $20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is $13.2 million ($20 million - $6.8 million) which is reported on the “Aggregate write-ins for gains and losses in surplus” line in the Capital and Surplus account. $6.8 million (34% of $20 million) is reported as income on the “Commissions and expense allowances on reinsurance ceded” line of the Summary of Operations.}

At the end of year N+1 the business has earned $4 million. ABC has paid $.5 million in profit and risk charges in arrears for the year and has received a $1 million experience refund. Company ABC’s annual statement would report $1.65 million (66% of ($4 million - $1 million - $.5 million) up to a maximum of $13.2 million) on the “Commissions and expense allowance on reinsurance ceded” line of the Summary of Operations, and -$1.65 million on the “Aggregate write-ins for gains and losses in surplus” line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.}

40. The Annual Statement Instructions require the following disclosures for Subscriber Savings Accounts:

Instruction:

For reciprocal insurance companies only, describe the amount of surplus identified as subscriber savings accounts; indicate the source of the funds (either from the reciprocal’s operations or contribution by the individual subscriber) and, the reporting location in surplus; and describe the conditions upon which the balances are paid to the subscribers.

Illustration:

At December 31, 19XX the Company has $_____ identified to subscriber savings accounts. Of this amount, $_____ is from company operations and is reported in Unassigned Funds (Page 3, Line 24C). The balance identified to subscriber savings account, $____, was contributed directly by subscribers and is separately reported in Other Than Special Surplus Funds (Page 3,
Line 23C). The subscriber savings account balances are paid to the subscribers upon the termination from the Company.

**Generally Accepted Accounting Principles**

41. ARB 43, Chapter 1, *Prior Opinions*, provides the following guidance:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made there against. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

Section B -- Opinion Issued by Predecessor Committee

1. Following an inquiry made by the New York Stock Exchange, a predecessor committee on accounting procedure in 1938 issued the following report:

“Profits or Losses on Treasury Stock”

2. “The executive committee of the American Institute of Accountants has directed that the following report of the committee on accounting procedure, which it received at a meeting on April 8, 1938, be published, without approval or disapproval of the committee, for the information of members of the Institute:
To the Executive Committee,
American Institute of Accountants:

3. “This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute’s special committee on cooperation with stock exchanges.

4. “As a result of discussions which then took place, the special committee on cooperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:

5. “Should the difference between the purchase and resale prices of a corporation’s own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?”

6. “The opinion of the special committee on cooperation with stock exchanges reads in part as follows:

7. “Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation’s common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation’s own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock.”

8. “This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.

9. “The special committee on cooperation with stock exchanges continued and concluded its report with the following statement:

10. “Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account).”

11. “This committee agrees with the special committee on cooperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions in the aggregate are of substantial importance.

12. “This committee recommends that the views expressed be circulated for the information of members of the Institute.”

42. APB 12, Omnibus Opinion 1967, provides the following guidance:

9. Paragraph 7 of APB Opinion No. 9, Reporting the Results of Operations, states that “The statement of income and the statement of retained earnings (separately or combined) are designed to reflect, in a broad sense, the ‘results of operations.’” Paragraph 28 of APB Opinion No. 9 states that certain capital transactions “... should be excluded from the determination of net income or the results of operations under all circumstances.” Companies generally have reported the current year’s changes in stockholders’ equity accounts other than retained earnings in separate statements or notes to the financial statements when presenting both financial position and results of operations for one or more years. A question has arisen as to whether,
because of the language of APB Opinion No. 9, changes in stockholders’ equity accounts other
than retained earnings are required to be reported.

10. When both financial position and results of operations are presented, disclosure of
changes in the separate accounts comprising stockholders’ equity (in addition to retained
earnings) and of the changes in the number of shares of equity securities during at least the most
recent annual fiscal period and any subsequent interim period presented is required to make the
financial statements sufficiently informative. Disclosure of such changes may take the form of
separate statements or may be made in the basic financial statements or notes thereto.

43. Accounting Principles Board Opinion No. 9, Reporting the Results of Operations, provides the
following guidance:

Capital Transactions

28. The Board reaffirms the conclusion of the former committee on accounting procedure
that the following should be excluded from the determination of net income or the results of
operations under all circumstances: (a) adjustments or charges or credits resulting from
transactions in the company’s own capital stock, 5 (b) transfers to and from accounts properly
designated as appropriated retained earnings (such as general purpose contingency reserves or
provisions for replacement costs of fixed assets) and (c) adjustments made pursuant to a quasi-
reorganization.

44. APB 10, Omnibus Opinion - 1966 requires the following disclosures for liquidation preferences:

10. Companies at times issue preferred (or other senior) stock which has a preference in
involuntary liquidation considerably in excess of the par or stated value of the shares. The
relationship between this preference in liquidation and the par or stated value of the shares may
be of major significance to the users of the financial statements of those companies and the
Board believes it highly desirable that it be prominently disclosed. Accordingly, the Board
recommends that, in these cases, the liquidation preference of the stock be disclosed in the
equity section of the balance sheet in the aggregate, either parenthetically or “in short,” rather
than on a per share basis or by disclosure in notes.

11. In addition, the financial statements should disclose, either on the face of the balance
sheet or in notes pertaining thereto:

a. the aggregate or per share amounts at which preferred shares may be called or
are subject to redemption through sinking fund operations or otherwise;
b. the aggregate and per share amounts of arrearages in cumulative preferred
dividends.

45. FAS 5 provides the following guidance with respect to appropriations of retained earnings:

Appropriation of Retained Earnings

15. Some enterprises have classified a portion of retained earnings as “appropriated” for loss
contingencies. In some cases, the appropriation has been shown outside the stockholders’ equity
section of the balance sheet. Appropriation of retained earnings is not prohibited by this
Statement provided that it is shown within the stockholders’ equity section of the balance sheet
and is clearly identified as an appropriation of retained earnings. Costs or losses shall not be
charged to an appropriation of retained earnings, and no part of the appropriation shall be
transferred to income.

46. APB 6, Status of Accounting Research Bulletins provides the following guidance for treasury
stock transactions:

12. The Board considers that the following accounting practices, in addition to the accounting
practices indicated in Chapter 1B, are acceptable, and that they appear to be more in accord with
current developments in practice:
a. When a corporation’s stock is retired, or purchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws):

   i. an excess of purchase price over par or stated value may be allocated between capital surplus and retained earnings. The portion of the excess allocated to capital surplus should be limited to the sum of (a) all capital surplus arising from previous retirements and net “gains” on sales of treasury stock of the same issue and (b) the prorata portion of capital surplus paid in, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining capital surplus applicable to issues fully retired (formal or constructive) is deemed to be applicable prorata to shares of common stock. Alternatively, the excess may be charged entirely to retained earnings in recognition of the fact that a corporation can always capitalize or allocate retained earnings for such purposes.

   ii. an excess of par or stated value over purchase price should be credited to capital surplus.

b. When a corporation’s stock is acquired for purposes other than retirement (formal or constructive), or when ultimate disposition has not yet been decided, the cost of acquired stock may be shown separately as a deduction from the total of capital stock, capital surplus, and retained earnings, or may be accorded the accounting treatment appropriate for retired stock, or in some circumstances may be shown as an asset in accordance with paragraph 4 of Chapter 1A of ARB 43. “Gains” on sales of treasury stock not previously accounted for as constructively retired should be credited to capital surplus; “losses” may be changed to capital surplus to the extent that previous net “gains” from sales or retirements of the same class of stock are included therein, otherwise to retained earnings.

c. Treasury stock delivered to effect a “pooling of interests” should be accounted for as though it were newly issued, and the cost thereof should receive the accounting treatment appropriate for retired stock.

13. Laws of some states govern the circumstances under which a corporation may acquire its own stock and prescribe the accounting treatment therefore. Where such requirements are at variance with paragraph 12, the accounting should conform to the applicable law. When state laws relating to acquisition of stock restrict the availability of retained earnings for payment of dividends or have other effects of a significant nature, these facts should be disclosed.

47. EITF 85-1, Classifying Notes Received for Capital Stock, provides the following guidance.

   Issue
   An enterprise receives a note, rather than cash, as a contribution to its equity. The transaction may be a sale of capital stock or a contribution to paid-in capital.

   The issue is whether an enterprise should report the note receivable as a reduction of shareholders’ equity or as an asset.

   EITF Discussion
   The Task Force reached a consensus that reporting the note as an asset is generally not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time. Some Task Force members would require collateralization, or payment of the note prior to issuance of the financial statements, to permit asset recognition.

   The SEC requires that public companies report notes received in payment for the enterprise’s stock as a deduction from shareholders’ equity. Task Force members confirmed that the
predominant practice is to offset the notes and stock in the equity section. However, such notes may be recorded as an asset if collected in cash prior to issuance of the financial statements.

Some Task Force members stated that they were aware of very few cases in which nonpublic companies reported such notes as an asset except in circumstances in which they (1) were secured by irrevocable letters of credit or other liquid collateral or were discountable at a bank and (2) included a stated maturity in a reasonably short period of time.

The SEC Observer stated that, for registrants, exceptions to the general rule would be very rare.

Status
No further EITF discussion is planned.

48. ARB 43, Chapter 7B, Stock Dividends and Split-ups, provides the following guidance:

Section B -- Stock Dividends and Stock Split-ups

1. The term stock dividend as used in this section refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

2. The term stock split-up as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

3. This chapter is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

4. The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.

As to the Issuer
Stock dividends

10. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation’s assets or its respective shareholders’ proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a dividend in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent...
otherwise dictated by legal requirements, in earned surplus subject to possible further similar
stock issuances or cash distributions.

11. Where the number of additional shares issued as a stock dividend is so great that it has,
or may reasonably be expected to have, the effect of materially reducing the share market value,
the committee believes that the implications and possible constructions discussed in the
preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature
of a stock split-up as defined in paragraph 2. Consequently, the committee considers that under
such circumstances there is no need to capitalize earned surplus, other than to the extent
occasioned by legal requirements. It recommends, however, that in such instances every effort
be made to avoid the use of the word dividend in related corporate resolutions, notices, and
announcements and that, in those cases where because of legal requirements this cannot be
done, the transaction be described, for example, as a split-up effected in the form of a dividend.

12. In cases of closely-held companies, it is to be presumed that the intimate knowledge of
the corporations' affairs possessed by their shareholders would preclude any such implications
and possible constructions as are referred to in paragraph 10. In such cases, the committee
believes that considerations of public policy do not arise and that there is no need to capitalize
earned surplus other than to meet legal requirements.

13. Obviously, the point at which the relative size of the additional shares issued becomes
large enough to materially influence the unit market price of the stock will vary with individual
companies and under differing market conditions and, hence, no single percentage can be laid
down as a standard for determining when capitalization of earned surplus in excess of legal
requirements is called for and when it is not. However, on the basis of a review of market action
in the case of shares of a number of companies having relatively recent stock distributions, it
would appear that there would be few instances involving the issuance of additional shares of
less than, say, 20% or 25% of the number previously outstanding where the effect would not be
such as to call for the procedure referred to in paragraph 10.

14. The corporate accounting recommended in paragraph 10 will in many cases, probably
the majority, result in the capitalization of earned surplus in an amount in excess of that called for
by the laws of the state of incorporation; such laws generally require the capitalization only of the
par value of the shares issued, or, in the case of shares without par value, an amount usually
within the discretion of the board of directors. However, these legal requirements are, in effect,
minimum requirements and do not prevent the capitalization of a larger amount per share.

Stock Split-ups

15. Earlier in this chapter a stock split-up was defined as being confined to transactions
involving the issuance of shares, without consideration moving to the corporation, for the purpose
of effecting a reduction in the unit market price of shares of the class issued and, thus, of
obtaining wider distribution and improved marketability of the shares. Where this is clearly the
intent, no transfer from earned surplus to capital surplus or capital stock account is called for,
other than to the extent occasioned by legal requirements. It is believed, however, that few cases
will arise where the aforementioned purpose can be accomplished through an issuance of shares
which is less than, say, 20% or 25% of the previously outstanding shares.

16. The committee believes that the corporation's representations to its shareholders as to
the nature of the issuance is one of the principal considerations in determining whether it should
be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new
shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the
frequent recurrence of issuances of shares, would destroy the presumption that transactions
represented to be split-ups should be recorded as split-ups.
RELEVANT LITERATURE

Statutory Accounting
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 23, Capital Stock, Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, Chapter 25, Unassigned Funds (Surplus)
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 26, Capital Stock, Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus, Chapter 28, Unassigned Funds (Surplus)
- NAIC Annual Statement Instructions
- Life and Health Reinsurance Agreements Model Regulation
- Issue Paper No. 3—Accounting Changes
- Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 9—Subsequent Events
- Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 73—Nonmonetary Transactions
- Issue Paper No. 41—Surplus Notes
- Issue Paper No. 75—Property and Casualty Reinsurance
- Issue Paper No. 78—Employee Stock Ownership Plans
- Issue Paper No. 80—Debt
- Issue Paper No. 81—Foreign Currency Transactions and Translations
- Issue Paper No. 82—Stock Option and Stock Purchase Plans
- Issue Paper No. 83—Accounting for Income Taxes
- Issue Paper No. 84—Quasi-reorganizations

Generally Accepted Accounting Principles
- AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies
- Accounting Research Bulletin No. 43, Chapter 1, Prior Opinions. Chapter 7B, Stock Dividends and Stock Split-ups
- Accounting Principles Board Opinion No. 6, Status of Accounting Research
- Accounting Principles Board Opinion No. 9, Reporting the Results of Operations Bulletins
- Accounting Principles Board Opinion No. 10, Omnibus Opinion 1966
- Accounting Principles Board Opinion No. 12, Omnibus Opinion 1967
- Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants
- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Emerging Issues Task Force Issue No. 85-1, Classifying Notes Received for Capital Stock
- FASB Emerging Issues Task Force Issue No. 85-2, Classification of Costs Incurred in a Takeover Defense
- FASB Emerging Issues Task Force Issue No. 88-9, Put Warrants
- FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 73

Nonmonetary Transactions

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE


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

SUMMARY CONCLUSION

4. The definitions of certain terms used in this issue paper are:

   a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash; amounts due from agents, brokers, and intermediaries; policy loans; accounts payable and other amounts receivable or payable in cash.

   b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are investments in common stocks; furniture fixtures and equipment; real estate and liabilities for rent collected in advance.

   c. Exchange (or exchange transaction) is a reciprocal transfer between a reporting entity and another entity that results in the reporting entity acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.

   d. Nonreciprocal transfer is a transfer of assets or services in one direction, either from a reporting entity to its owners (whether or not in exchange for their ownership interests) or another entity, or from owners or another entity to the reporting entity. A reporting entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.
5. Except as addressed in other issue papers, as discussed in paragraph 11 of this issue paper, nonmonetary transactions shall be accounted for in accordance with APB 29 which is excerpted in paragraph 20 of this issue paper. The accounting for such transactions shall be based on the fair values, as defined in APB 29, paragraph 25, of the assets (or services) involved. In a reciprocal transfer, the fair value of the asset surrendered shall be used to measure the cost unless the fair value of the asset received is more clearly evident. A nonmonetary asset received in a nonreciprocal transfer shall be recorded at the fair value of the asset received. A nonmonetary asset transferred to a stockholder or other entity in a nonreciprocal transfer shall be accounted for at the fair value of the asset transferred and a gain or loss on disposition of the asset recognized for the difference, if any, between fair value and carrying value of the asset transferred.

6. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities, Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities), Issue Paper No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities), Issue Paper No. 37—Mortgage Loans, Issue Paper No. 39—Reverse Mortgages, Issue Paper No. 40—Real Estate Investments, Issue Paper No. 43—Loan-Backed and Structured Securities or other applicable statement. The guidance provided in Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties shall be followed in accounting for nonreciprocal transactions.

7. Stock received in the form of a stock dividend or stock split shall not result in the recognition of income. The cost basis of stock held shall be reallocated ratably to the total shares held after receipt of the stock dividend or stock split.

8. Involuntary conversions of nonmonetary assets to monetary assets (for example, as a result of total or partial destruction, theft, seizure, or condemnation) are monetary transactions for which gain or loss shall be recognized even though a reporting entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with the conclusions in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) or Issue Paper No. 20—Gain Contingencies (Issue Paper No. 20), as applicable. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be reported consistently with the reporting entity’s reporting of continuing operations and disclosed in the notes to financial statements in accordance with Issue Paper No. 24—Discontinued Operations and Extraordinary Items (Issue Paper No. 24).

9. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for in accordance with Issue Paper No. 83—Accounting for Income Taxes.

Disclosure
10. A reporting entity that engages in a nonmonetary transaction during a period shall disclose in the financial statements or notes thereto the nature of the transaction, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.
DISCUSSION

11. Although not meant to be all inclusive, accounting for specific nonmonetary transactions and unique circumstances is addressed in the following issue papers:

- Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (Issue Paper No. 25),
- Issue Paper No. 68—Business Combinations and Goodwill,
- Issue Paper No. 72—Statutory Surplus,
- Issue Paper No. 78—Employee Stock Ownership Plans, and
- Issue Paper No. 82—Stock Option and Stock Purchase Plans.

12. This issue paper establishes a general rule for accounting for nonmonetary transactions not specifically addressed in the issue papers noted above and expands on current statutory guidance to establish guidance for stock dividends and stock splits received, other types of nonmonetary transactions and involuntary conversions of nonmonetary assets to monetary assets. The guidance established in this issue paper is consistent with the guidance provided in Issue Paper No. 30 which addresses cash dividends and requires that dividends on common stock be recorded as investment income when declared with a corresponding receivable to be extinguished upon receipt of cash. This issue paper also expands the disclosure requirements related to nonmonetary transactions.

13. This issue paper adopts APB 29.

14. This issue paper adopts ARB 43, Chapter 7, Section B paragraphs 1 through 9 as such relates to the receipt of stock in the form of a stock dividend or stock split. This conclusion is consistent with the recognition concept included in the Statement of Concepts which states “Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed”.

15. This issue paper adopts FIN 30 with modification to provide that gain or loss contingencies be recognized in accordance with the conclusions in Issue Paper No. 5 or Issue Paper No. 20, as applicable, and that gain or loss resulting from an involuntary conversion of nonmonetary assets to monetary assets be accounted for in continuing operations and disclosed in accordance with Issue Paper No. 24.

16. This issue paper adopts EITF 86-29 and EITF 93-11 consistent with the general rule discussed in paragraph 12 above.

17. This issue paper rejects paragraph 16 of Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins and Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners.

18. The conclusions above are consistent with the recognition concept included in the Statement of Concepts. The recognition concept states:

The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise’s ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

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

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

Generally Accepted Accounting Principles
20. APB 29 provides the following guidance:

INTRODUCTION

1. Most business transactions involve exchanges of cash or other monetary assets or liabilities for goods or services. The amount of monetary assets or liabilities exchanged generally provides an objective basis for measuring the cost of nonmonetary assets or services received by an enterprise as well as for measuring gain or loss on nonmonetary assets transferred from an enterprise. Some transactions, however, involve either (a) an exchange with another entity (reciprocal transfer) that involves principally nonmonetary assets or liabilities or (b) a transfer of nonmonetary assets for which no assets are received or relinquished in exchange (nonreciprocal transfer). Both exchanges and nonreciprocal transfers that involve little or no monetary assets or liabilities are referred to in this section as nonmonetary transactions.

2. Questions have been raised concerning the determination of the amount to assign to a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction and also concerning the recognition of a gain or loss on a nonmonetary asset transferred from an enterprise in a nonmonetary transaction. Practice has varied; some nonmonetary transactions have been accounted for at the estimated fair value of the assets transferred and some at the amounts at which the assets transferred were previously recorded. This opinion sets forth the views of the Board on accounting for nonmonetary transactions.

1 See paragraph 3 of this Opinion for definitions of these terms.
Definitions

3. The meanings of certain terms used in this section are:
   
   a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short- or long-term accounts and notes receivable in cash, and short- or long-term accounts and notes payable in cash.\(^2\)

   b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are inventories; investments in common stocks; property, plant and equipment; and liabilities for rent collected in advance.\(^2\)

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   \(^2\) APB Statement No. 3, Financial Statements Restated for General Price-Level Changes, paragraphs 17-19, and Appendix B, contains a more complete explanation of monetary and nonmonetary items.

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   c. Exchange (or exchange transaction) is a reciprocal transfer between an enterprise and another entity that results in the enterprise's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.\(^3\)

   d. Nonreciprocal transfer\(^3\) is a transfer of assets or services in one direction, either from an enterprise to its owners (whether or not in exchange for their ownership interests) or another entity or from owners or another entity to the enterprise. An entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

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   \(^3\) APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, paragraphs 180-183, contains a more complete explanation of exchanges and nonreciprocal transfers.

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   e. Productive assets are assets held for or used in the production of goods or services by the enterprise. Productive assets include an investment in another entity if the investment is accounted for by the equity method but exclude an investment not accounted for by that method. Similar productive assets are productive assets that are of the same general type, that perform the same function or that are employed in the same line of business.

Applicability

4. This Opinion does not apply to the following transactions:

   a. A business combination accounted for by an enterprise according to the provisions of APB Opinion No. 16, Business Combinations,

   b. A transfer of nonmonetary assets solely between companies or persons under common control, such as between a parent company and its subsidiaries or between two subsidiary corporations of the same parent, or between a corporate joint venture and its owners,
c. Acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise,\textsuperscript{4} and

\hspace{1cm}

\textsuperscript{4} The Board has deferred consideration of accounting for those transactions pending completion and consideration of Accounting Research Studies on intercorporate investments and stockholders' equity except to the extent they are covered in \textit{APB Opinion No. 25, Accounting for Stock Issued to Employees}.

d. Stock issued or received in stock dividends and stock splits which are accounted for in accordance with ARB No. 43, Chapter 7B.

This Opinion applies to regulated companies in accordance with the Addendum to \textit{APB Opinion No. 2, Accounting for the Investment Credit, 1962} and it amends \textit{APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises}, to the extent it relates to measuring transfers of certain nonmonetary assets. Some exchanges of nonmonetary assets involve a small monetary consideration, referred to as “boot,” even though the exchange is essentially nonmonetary. This Opinion also applies to those transactions. For purposes of applying this Opinion, events and transactions in which nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets--are monetary transactions since the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets.

\textbf{DISCUSSION}

\textbf{Present Accounting for Nonmonetary Transactions}

5. Nonreciprocal Transfers with Owners. Some nonmonetary transactions are nonreciprocal transfers between an enterprise and its owners. Examples include (a) distribution of nonmonetary assets, such as marketable equity securities, to stockholders as dividends, (b) distribution of nonmonetary assets, such as marketable equity securities, to stockholders to redeem or acquire outstanding capital stock of the enterprise, (c) distribution of nonmonetary assets, such as capital stock of subsidiaries, to stockholders in corporate liquidations or plans of reorganization that involve disposing of all or a significant segment of the business (the plans are variously referred to as spin-offs, split-ups, and split-offs), and (d) distribution of nonmonetary assets to groups of stockholders, pursuant to plans of rescission or other settlements relating to a prior business combination, to redeem or acquire shares of capital stock previously issued in a business combination. Accounting for decreases in owners' equity that result from nonreciprocal nonmonetary transactions with owners has usually been based on the recorded amount of the nonmonetary assets distributed.

6. Nonreciprocal Transfers with Other Than Owners. Other nonmonetary transactions are nonreciprocal transfers between an enterprise and entities other than its owners. Examples are the contribution of nonmonetary assets by an enterprise to a charitable organization and the contribution of land by a governmental unit for construction of productive facilities by an enterprise. Accounting for nonmonetary assets received in a nonreciprocal transfer from an entity other than an owner has usually been based on fair value of the assets received while accounting for nonmonetary assets transferred to another entity has usually been based on the recorded amount of the assets relinquished.

7. Nonmonetary Exchanges. Many nonmonetary transactions are exchanges of nonmonetary assets or services with another entity. Examples include (a) exchange of product held for sale in the ordinary course of business (inventory) for dissimilar property as a means of selling the product to a customer, (b) exchange of product held for sale in the ordinary course of business (inventory) for similar product as an accommodation - that is, at least one party to the exchange reduces transportation costs, meets immediate inventory needs, or otherwise reduces
costs or facilitates ultimate sale of the product—and not as a means of selling the product to a
customer, and (c) exchange of productive assets—assets employed in production rather than held
for sale in the ordinary course of business - for similar productive assets or for an equivalent
interest in similar productive assets. Examples of exchanges in category (c) include the trade of
player contracts by professional sports organizations, exchange of leases on mineral properties,
exchange of one form of interest in an oil producing property for another form of interest,
exchange of real estate for real estate. Accounting for nonmonetary assets acquired in a
nonmonetary exchange has sometimes been based on the fair value of the assets relinquished
and sometimes on the recorded amount of the assets relinquished.

Differing Views

8. Views of accountants differ as to appropriate accounting for all of the types of
nonmonetary transactions described in paragraphs 5 to 7.

9. Nonreciprocal Transfers of Nonmonetary Assets to Owners. Some believe that
accounting for nonreciprocal transfers of nonmonetary assets to owners should be based on the
carrying amount of the nonmonetary assets transferred because only that method is consistent
with the historical cost basis of accounting.

10. Others believe that accounting for transfers of nonmonetary assets to reduce certain
owners' interests other than through a reorganization, liquidation, or rescission of a prior business
combination should be based on the fair value of the nonmonetary assets distributed or the fair
value of the stock representing the owners' equity eliminated, whichever is more clearly evident.
In their view, disposing of the value represented by a nonmonetary asset is a significant
economic event, and the unrecorded increase or decrease that has resulted in the value of the
nonmonetary asset since its acquisition should be recognized.

11. Many who agree with accounting based on fair value for a nonreciprocal transfer of a
nonmonetary asset that reduces certain owners' interests also believe that distributing a
nonmonetary asset as an ordinary dividend (but not distributing a nonmonetary asset as a
liquidating dividend or in a spin-off, reorganization or similar distributions) may be regarded as
equivalent to an exchange with owners and therefore recorded at the fair value of the
nonmonetary asset distributed, particularly if the dividend is distributable as either cash or the
nonmonetary asset at the election of the owner. They believe that failure to recognize the fair
value of nonmonetary assets transferred may both misstate the dividend and fail to recognize
gains and losses on nonmonetary assets that have already been earned or incurred by the
enterprise and should be recognized on distributing the assets for dividend purposes.

12. Others generally agree with the view that nonreciprocal transfers of nonmonetary assets
to certain owners should be accounted for at fair value but believe that dividends and other
prorata distributions to owners are essentially similar to liquidating dividends or distributions in
spin-offs and reorganizations and should be accounted for at the recorded amount of the asset
transferred.

13. Nonreciprocal Receipts of Nonmonetary Assets. Many believe that a nonmonetary asset
received in a nonreciprocal transfer from other than owners should be recorded at fair value
because fair value is the only value relevant to the recipient enterprise. Others believe that such
nonmonetary assets should be recorded at a nominal value since fair value cannot be reasonably
determined in view of performance obligations usually agreed to by the recipient as a
consideration for the transfer.

14. Nonreciprocal Transfers of Nonmonetary Assets to Other Than Owners. Some believe
that accounting for a nonreciprocal transfer of a nonmonetary asset to an entity other than an
owner should be based on the carrying amount of the asset transferred because only that
method is consistent with the historical cost basis of accounting. Others believe that failure to
recognize the fair value of a nonmonetary asset transferred may both understate (or overstate)
expenses incurred and fail to recognize gains or losses on nonmonetary assets that have already
been earned or incurred by the enterprise and should be recognized when the transfer of the asset is recognized as an expense.

15. Exchange Transactions. Some believe that accounting for an exchange of nonmonetary assets between an enterprise and another entity (an enterprise or individual acting in a capacity other than a stockholder of the enterprise) should be based on the fair values of the assets involved, while others believe that accounting for the exchange should be based on the carrying amount of the asset transferred from the enterprise. Those who advocate the former view believe it to be the only method consistent with the accounting principle that an asset acquired should be recorded at its cost as measured by the fair value of the asset relinquished to acquire it. Those advocating the latter view believe that revenue should be recognized only if an exchange involves monetary assets; therefore recognizing fair value is inappropriate unless a monetary asset is received in an exchange.

16. Many accountants who accept the concept that accounting for an exchange of nonmonetary assets should be based on fair value believe that problems of measurement and questions about the conditions for recognizing revenue require modification of the concept in two types of exchanges. They therefore conclude that:

   a. Fair values should not be recognized if an enterprise exchanges product or property held for sale in the ordinary course of business for product or property to be sold in the same line of business. The emphasis in that exchange, in their view, is on developing economical ways to acquire inventory for resale to customers rather than on marketing inventory to obtain revenue from customers. Therefore, “swapping” inventories between enterprises that are essentially competitors and not customers of each other is merely an incidental early stage of an earning process, and revenue should not be recognized until the time of sale of the exchanged products (in the same or another form) to a customer of the enterprise.

   b. Fair value should not be recognized if an enterprise exchanges a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset. Therefore, revenue should not be recognized merely because one productive asset is substituted for a similar productive asset but rather should be considered to flow from the production and sale of the goods or services to which the substituted productive asset is committed.

17. Fair Value Not Determinable. General agreement exists that a nonmonetary transaction, regardless of form, should not be recorded at fair value if fair value is not determinable within reasonable limits. Major uncertainties concerning realizability of the fair value proposed to be assigned to a nonmonetary asset received in a nonmonetary transaction are indicative of an inability to determine fair value within reasonable limits. Some believe that only an exchange transaction between parties with essentially opposing interests provides an independent test of fair value to be used in measuring the transaction; therefore fair value is determinable within reasonable limits only in a negotiated exchange transaction. Others believe that fair value in a nonreciprocal transfer is also often determinable within reasonable limits and should be recognized in certain types of transactions.
OPINION

Basic Principle

18. The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values\(^5\) of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).

\(^5\) See paragraph 25 for determination of fair value.

19. The Board believes that certain modifications of the basic principle are required to accommodate problems of measurement and questions about the conditions for recognizing revenue. These modifications are specified in paragraphs 20 to 23.

Modifications of the Basic Principle

20. Fair Value Not Determinable. Accounting for a nonmonetary transaction should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits (paragraph 25).

21. Exchanges. If the exchange is not essentially the culmination of an earning process, accounting for an exchange of a nonmonetary asset between an enterprise and another entity should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset relinquished. The Board believes that the following two types of nonmonetary exchange transactions do not culminate an earning process:

a. An exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange, and

b. An exchange of a productive asset not held for sale in the ordinary course of business for a similar productive asset or an equivalent interest in the same or similar productive asset (similar productive asset is defined in paragraph 3 and examples are given in paragraph 7).\(^6\)

\(^6\) The fact that an exchange of productive assets is not a taxable transaction for tax purposes may be evidence that the assets exchanged are similar for purposes of applying this Opinion.

22. The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraph 21) may include an amount of monetary consideration. The Board believes that the recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of
the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. The Board further believes that the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraph 21 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraph 21, the entire indicated loss on the exchange should be recognized.

23. Nonreciprocal Transfers to Owners. Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary assets distributed. A prorata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

Applying the Basic Principle

24. The Board's conclusions modify to some extent existing practices as described in paragraphs 5 to 7. The conclusions are based on supporting reasons given in paragraphs 8 to 17.

25. Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

26. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value. An exchange involving parties with essentially opposing interests is not considered a prerequisite to determining a fair value of a nonmonetary asset transferred; nor does an exchange insure that a fair value for accounting purposes can be ascertained within reasonable limits. If neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the enterprise may be the only available measure of the transaction.

27. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for according to FASB Statement No. 109, Accounting for Income Taxes.
Disclosure

28. An enterprise that engages in one or more nonmonetary transactions during a period should disclose in financial statements for the period the nature of the transactions, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.7

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7 Paragraph 12 of ARB No 51, Consolidated Financial Statements, includes additional disclosures that are preferred if a parent company disposes of a subsidiary during the year.

21. ARB 43, Chapter 7, Section B provides the following guidance (only the pertinent excerpts are included below):

As to the Recipient

5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this chapter. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the separate entity concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known.1 The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in Eisner v. Macomber, 252 U.S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

“A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased ... the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones.”

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9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.
22. FIN 30 provides the following guidance (only the pertinent excerpts are included below):

1. The FASB has been asked whether gain or loss results from an involuntary conversion of a nonmonetary asset to monetary assets if the monetary assets are subsequently reinvested in a similar nonmonetary asset.\(^1\) Generally, if a nonmonetary asset is involuntarily converted, gain or loss for the difference between the cost\(^2\) of the nonmonetary asset and the amount of monetary assets received has been recognized in income in the period of the involuntary conversion. In other cases, that difference has been accounted for as an adjustment to the cost basis of a nonmonetary asset that is subsequently acquired as replacement property.

\(^1\) The terms “nonmonetary” and “monetary” as used in this Interpretation have the same meaning as those terms have in APB Opinion No. 29, Accounting for Nonmonetary Transactions.

\(^2\) As used in this Interpretation, the term cost refers to the cost of a nonmonetary asset or to its carrying amount, if different.

**INTERPRETATION**

2. Involuntary conversions of nonmonetary assets to monetary assets are monetary transactions for which gain or loss shall be recognized even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. As discussed in paragraph 11 of this Interpretation, however, the requirement to recognize gain does not apply to certain involuntary conversions of LIFO inventories.\(^3\)

\(^3\) Paragraph 14(b) of APB Opinion No. 28, Interim Financial Reporting, provides an exception for the liquidation of a LIFO inventory at an interim date if replacement is expected by year-end. Accordingly, that exception applies to an involuntary conversion of a LIFO inventory if replacement is expected by year-end.

3. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with FASB Statement No. 5, Accounting for Contingencies.

4. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be classified in accordance with the provisions of APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.

5. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets that is not recognized for income tax reporting purposes in the same period in which the gain or loss is recognized for financial reporting purposes is a temporary difference for which comprehensive recognition of deferred taxes, as described in FASB Statement No. 109, Accounting for Income Taxes, is required.

23. EITF 86-29 provides the following guidance (only the pertinent excerpts are included below):

**ISSUE**

The basic principle contained in Opinion 29 is that the exchange of nonmonetary assets should be recorded at fair value. Certain modifications to that basic principle are contained in paragraphs 21 and 22 of Opinion 29. (The Task Force previously discussed certain aspects of those modifications in Issues No. 84-29, “Gain and Loss Recognition on Exchanges of Productive Assets and the Effect of Boot,” and No. 85-43, “Sale of Subsidiary for Equity Interest in Buyer.”)
The issues are (1) how the accounting for certain nonmonetary transactions should be affected by the magnitude of boot and (2) how the exceptions to the use of fair value should be applied.

EITF DISCUSSION

The Task Force reached a consensus that the decision as to whether an exchange involving products or properties held for sale (paragraph 21(a) of Opinion 29) should be measured using the recorded amounts or fair value depends on whether the products or properties received will be sold in the same line of business as the products or properties given up.

Further, the Task Force reached a consensus that the decision as to whether an exchange of similar productive assets (paragraph 21(b)) should be measured using the recorded amounts or fair value should be based on a “same line of business” test.

Some Task Force members expressed the view that the exchange of a controlled business (as defined in ARB 51) for an investment in an entity that is not controlled, but is in the same line of business, would not necessarily meet the definition of a similar productive asset and would have to be evaluated based on individual facts and circumstances. No consensus was reached on this issue.

The Task Force reached a consensus that a product or property held for sale and exchanged for a productive asset did not fall within the modifications to the basic principle of Opinion 29 (even if they were in the same line of business) and should be recorded at fair value.

The Task Force discussed an exchange of nonmonetary assets that would otherwise be based on recorded amounts but that also involves boot, reached a consensus that the transaction should be considered monetary (rather than nonmonetary) if the boot is significant, and agreed that “significant” should be defined as at least 25 percent of the fair value of the exchange. As a monetary transaction, both parties would record the exchange at fair value. If the boot in a transaction is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 should be applied by the receiver of boot, and the payer of boot would not recognize a gain. The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite to the use of fair value.

The Task Force also discussed various exchanges involving investments accounted for by consolidation and by the equity method. The Task Force reached a consensus that an enterprise should account for an exchange of securities in which it acquires control of a subsidiary as a business combination in accordance with Opinion 16. An enterprise should account for an exchange of securities accounted for by consolidation or by the equity method for an investment in which it does not acquire control of a business but for which it will account by the equity method, as a nonmonetary transaction in accordance with Opinion 29. The Task Force noted that the provisions of this consensus were not intended to apply to exchanges involving joint ventures or the acquisition of a minority interest.

Additionally, several Task Force members and the SEC Observer expressed concern that a literal application of the consensus to an exchange in which an enterprise acquires control of a business could result in the recognition of gain on transactions that are in substance an exchange of similar productive assets or result in a 100 percent write-up of an asset in circumstances in which an entity has not transferred control of the asset. For example, Company A transfers an asset to Company B in exchange for shares of Company B. As a result of the exchange, Company A acquires control of Company B; Company A also indirectly retains control of the asset received by Company B. The Task Force agreed that Company A should account for this transaction as a partial sale (to minority shareholders of Company B), and gain recognition should be limited to that portion of the asset treated as sold. If Company B accounts for the exchange at fair value, profit applicable to the portion of the asset indirectly controlled by Company A would be eliminated in Company A’s consolidation of Company B.
Further, the Task Force observed that the consensus is not intended to change the application of Opinion 16 or to eliminate the need to exercise judgment in those circumstances in which the substance of a transaction indicates that fair value accounting is not appropriate. That is, if Opinion 16 is to apply, the substance of the transaction must be a business combination.

STATUS

Issues relating to the exchange of real estate involving boot were discussed in Issue No. 87-29, “Exchange of Real Estate Involving Boot.” For that Issue, the Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 86-29 because boot is at least 25 percent of the fair value of the exchange would be allocated between two components: a monetary portion and a nonmonetary portion. (An exchange of similar real estate is defined in Issue 87-29 as an exchange of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate.) The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. For the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. Exhibit 87-29A presents an example of the application of the consensus reached on Issue 87-29.

No further EITF discussion is planned.

24. EITF 93-11 provides the following guidance (only the pertinent excerpts are included below):

ISSUE

In a barter transaction involving barter credits, an enterprise enters into a transaction to exchange a nonmonetary asset (for example, inventory) for barter credits. Those transactions may occur directly between principals to the transaction or include a third party whose business is to facilitate those types of exchanges (for example, a barter company).

The barter credits can be used to purchase goods or services, such as advertising time, from either the barter company or members of its barter exchange network. The goods and services to be purchased may be specified in a barter contract or limited to items made available by members of the exchange network. Some arrangements may require the payment of cash in addition to the barter credits to purchase goods or services. Barter credits also may have a contractual expiration date, at which time they become worthless.

The issue is whether Opinion 29 should be applied to an exchange of a nonmonetary asset for barter credits and, if so, the amount of profit or loss, if any, that should be recognized.

EITF DISCUSSION

The Task Force reached a consensus that transactions in which nonmonetary assets are exchanged for barter credits should be accounted for under Opinion 29. An impairment of the nonmonetary asset exchanged should be recognized prior to recording the exchange if the fair value of that asset is less than its carrying amount. The impairment should be measured as the amount by which the carrying amount of the asset exceeds its fair value. Recognition of an impairment loss also would be required in an exchange of assets or contractual rights not reported in the balance sheet (for example, operating leases) if the transferor is not relieved of primary liability for the related obligation. The definition of fair value in paragraph 13 of Statement 15 may be useful in determining the fair value of the nonmonetary asset. The Task Force noted that fair value should not be based on an estimate of the value of the barter credits to be
received. After an impairment is recognized, the reduced carrying amount of the nonmonetary asset becomes its new cost. [Note: See STATUS section.]

If an exchange involves the transfer or assumption of an operating lease, impairment of that lease should be measured as the amount of the remaining lease costs (discounted rental payments and unamortized leasehold improvements) in excess of the discounted amount of probable sublease rentals for the remaining lease term. [Note: See STATUS section.]

The Task Force also reached a consensus that in reporting the exchange of a nonmonetary asset for barter credits, it should be presumed that the fair value of the nonmonetary asset exchanged is more clearly evident than the fair value of the barter credits received and that the barter credits should be reported at the fair value of the nonmonetary asset exchanged. The Task Force noted, however, that that presumption might be overcome if an entity can convert the barter credits into cash in the near term, as evidenced by a historical practice of converting barter credits into cash shortly after receipt, or if independent quoted market prices exist for items to be received upon exchange of the barter credits. It also should be presumed that the fair value of the nonmonetary asset does not exceed its carrying amount unless there is persuasive evidence supporting a higher value. An impairment loss on the barter credits should be recognized if it subsequently becomes apparent that (1) the fair value of any remaining barter credits is less than the carrying amount or (2) it is probable that the enterprise will not use all of the remaining barter credits.

STATUS

In March 1995, the FASB issued Statement 121 which requires that long-lived assets and certain identifiable intangibles to be held and used be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Statement 121 establishes accounting standards for the recognition and measurement of impairment losses and sets forth an approach to determining an asset's fair value. Statement 121 also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 20—Gain Contingencies
- Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated companies)
- Issue Paper No. 68—Business Combinations and Goodwill
- Issue Paper No. 72—Statutory Surplus
- Issue Paper No. 78—Employee Stock Ownership Plans
- Issue Paper No. 82—Stock Option and Stock Purchase Plans
- Issue Paper No. 83—Accounting for Income Taxes
Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, paragraph 16
- Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 7, Section B, Stock Dividends and Stock Split-ups
- FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets
- FASB Emerging Issues Task Force Issue No. 86-29, Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value
- FASB Emerging Issues Task Force Issue No. 93-11, Accounting for Barter Transactions Involving Barter Credits
- Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 74

Life, Deposit-Type and Accident and Health Reinsurance

STATUS
Finalized March 16, 1998

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Reinsurance is an agreement by which a reporting entity transfers all or part of its risk under a contract to another reporting entity. Current statutory guidance on the accounting for life and accident and health reinsurance is contained in Chapters 17, 21 and 24 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual).

2. GAAP guidance on the accounting for life and accident and health reinsurance is primarily contained in FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113). In several instances, FAS 113 differs from the current statutory guidance.

3. The purpose of this issue paper is to establish statutory accounting principles for reinsurance of life, deposit-type and accident and health contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to life and accident and health contracts and deposit-type contracts as defined in Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force (Issue Paper No. 50). The provisions of Chapter 24 of the Life/A&H Accounting Practices and Procedures Manual (Chapter 24) and the accounting related items in the proposed Actuarial Guideline JJJ - Guideline Concerning Questions and Answers Related to the Life and Health Reinsurance Agreements Model Regulation (the proposed Actuarial Guideline JJJ), which provided further clarification of reinsurance accounting as provided in Chapter 24, are adopted as the statutory accounting principles for life and accident and health reinsurance except that all deposit-type contracts reinsured are to be accounted for under the Deposit Accounting section of Chapter 24. Goodwill resulting from the deferral of losses by the assuming entity at the inception of assumption reinsurance agreements shall be included in the total goodwill of a reporting entity when calculating the amount of goodwill that is a nonadmitted asset pursuant to Issue Paper No. 68—Business Combinations and Goodwill.

5. With respect to other accounting matters, the provisions of Chapter 17 (included in paragraph 14 of this issue paper) of the Life/A&H Accounting Practices and Procedures Manual that relate to reinsurance in unauthorized companies and funds held under reinsurance treaties with unauthorized reinsurers are adopted as statutory accounting principles. The provisions of Chapter 21 (included in paragraph 15 of this issue paper) of the Life/A&H Accounting Practices and Procedures Manual that relate to commissions and expense allowances on ceded and assumed reinsurance are adopted as statutory accounting principles. In addition, the Annual Statement Instructions require reinsurance disclosures in notes 10 through 15 to the Annual Statement. These disclosures (included in paragraph 18 of this issue paper) are also adopted as statutory accounting principles.
6. If it is probable that reinsurance recoverables on paid or unpaid claim or benefit payments will be uncollectible, consistent with Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets, amounts shall be written off through a charge to the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.

DISCUSSION

7. The statutory accounting for life and accident and health reinsurance was recently revised through amendments to Chapter 24 and further clarified by the proposed Actuarial Guideline JJJ. The GAAP guidance for life and accident and health reinsurance is contained principally within FAS No. 113 which is adopted with modification for property and casualty reinsurance in Issue Paper No. 75—Property and Casualty Reinsurance and by this issue paper for life, deposit-type and accident and health reinsurance. This issue paper applies to all accident and health reinsurance written by life and health and property and casualty insurers. The statutory accounting principles established by this issue paper differ substantially from GAAP, reflecting much more detailed guidance as follows:

a. Reserve credits taken by ceding entities as a result of reinsurance contracts are netted against the ceding entity’s policy and claim reserves and unpaid claims. Under GAAP, reinsurance recoverables are reported as assets.

b. For statutory reporting, first year and renewal ceding commissions on indemnity reinsurance of new business (ceding commissions on ceded in-force business are included in the calculation of initial gain or loss, see paragraph 7.d.) are recognized as income. Under GAAP, ceding commissions are reported first as a reduction of deferred acquisition costs (DAC) and then if DAC is completely eliminated any excess is established as unearned revenue.

c. As discussed in Issue Paper No. 50, statutory accounting defines deposit-type contracts as those contracts which do not include any mortality or morbidity risk. GAAP defines investment contracts as those that do not subject the reporting entity to significant policyholder mortality or morbidity risk. (The distinction is any mortality or morbidity risk for statutory purposes vs. significant mortality or morbidity risk for GAAP purposes.) Therefore, a contract may be considered an investment contract for GAAP purposes, and that same contract may be considered other than deposit-type for statutory purposes. A reinsurance treaty covering contracts that have insignificant mortality or morbidity risk (i.e., contracts classified as other than deposit-type contracts for statutory purposes, but investment contracts for GAAP purposes) that does not transfer that mortality or morbidity risk, but does transfer all of the significant risk inherent in the business being reinsured (e.g., lapse, credit quality, reinvestment or disintermediation risk) qualifies for reinsurance accounting for statutory reporting purposes, but would not qualify for reinsurance accounting treatment for GAAP purposes.

d. For statutory reporting, initial gains or losses on indemnity reinsurance of in-force blocks of business have unique accounting treatment. A portion of the initial gains or losses (equal to the tax effect of the initial gain or loss in surplus) is reported as commissions and expense allowances on reinsurance ceded in the statement of operations. The remainder of the initial gains or losses is reported on a net-of-tax basis as a write-in for gain or loss in surplus in the Capital and Surplus Account. In subsequent years, the ceding entity recognizes income on the reinsurance ceded line for the net-of-tax profits that emerged on the reinsured block of business with a corresponding decrease in the write-in for gain or loss in surplus. Under GAAP, the cost of reinsurance is amortized to income over the life of the reinsured contracts or the reinsurance contract period, depending on whether the reinsurance contract is long or short-duration. The difference,
if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

e. Statutory accounting prohibits recognition of a gain or loss in connection with the sale, transfer or reinsurance of an in-force block of business between affiliated entities in a non-economic transaction. Any difference between the assets transferred by the ceding entity and the liabilities, including unamortized IMR, shall be deferred and amortized under the interest method. Under GAAP, such transactions are treated as capital contributions or dividends.

f. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.

g. Statutory accounting as defined in Chapter 24 prescribes offsetting certain reinsurance premiums. However, FAS 113 states that for GAAP, offsets can occur only when a right of setoff exists.

8. Amounts due from reinsurers on paid claims and benefits are reported as assets under both statutory accounting and GAAP. Reserve credits deducted by ceding entities from their direct and assumed policy and claim reserves and unpaid claims represent amounts that will be recovered from reinsurers. These reinsurance recoverables meet the statutory definition of an asset established in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets; however, this asset will continue to be presented as a contra liability in statutory financial statements because a change to “gross” presentation would necessitate extensive changes in and restatement of the reporting of ceded reinsurance in schedules and exhibits of the NAIC Annual Statement.

9. This issue paper maintains current statutory accounting principles that require that losses to the assuming entity at the inception of assumption reinsurance agreements (i.e., liabilities exceed assets) be deferred as goodwill and amortized over the life of the policies, but for a period not to exceed 10 years. This issue paper clarifies that goodwill recorded by an assuming entity related to an assumption reinsurance agreement shall be considered with goodwill of an entity in determining the amount of goodwill to be nonadmitted. If assets exceed liabilities at the inception of the assumption reinsurance agreement, the assuming entity shall record a deferred liability and amortize the amount using the interest method over the expected life of the business, but for a period not to exceed 10 years.

10. Issue Paper No. 52—Deposit-Type Contracts (Issue Paper No. 52) establishes statutory accounting principles for income recognition and policy reserves for deposit-type contracts. Under Issue Paper No. 52, reinsurance of deposit-type contracts, which by definition do not have insurance risk, will be accounted for under the provisions of the Deposit Accounting section of Chapter 24. This is consistent with the GAAP treatment of investment contracts under FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, but is inconsistent with reinsurance accounting treatment in Chapter 24 which would allow for reinsurance accounting treatment if the risks other than mortality and morbidity were transferred.

11. The impact of gains or losses from reinsurance of in-force blocks of business can be effectively monitored because such gains and losses are shown as a single line item in the surplus section.

12. The statutory accounting for non-economic assumption reinsurance transactions between affiliated entities is consistent with Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.

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13. The statutory requirement to establish a liability, Reinsurance in Unauthorized Companies, for unsecured reinsurance recoverables from unauthorized reinsurers is contained in various state statutes, the Life/A&H Accounting Practices and Procedures Manual (Chapter 17) and the Instructions to the Life, Accident and Health Annual Statement, Schedule S - Part 3. This requirement maintains current statutory accounting, and is consistent with the recognition concept and conservatism concept in the Statement of Concepts, which also allows for certain mandated liabilities.

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management’s accounting estimates, the ability to meet policyholders obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Drafting Notes/Comments
- Deposit accounting for Property and Casualty Companies is currently being considered by the AICPA. Codification may have to be amended to acknowledge an additional SAP/GAAP difference should the AICPA adopt guidance for Life Insurance Companies that differs from Chapter 24.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
14. Chapter 17 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on reinsurance in unauthorized companies:

Reinsurance in Unauthorized Companies

This liability is established to offset credit taken in various balance sheet accounts for reinsurance ceded to unauthorized reinsurers. Credit for reinsurance with unauthorized companies also may be permitted if the ceding company holds securities or cash of the assuming company equal to the reserve credit taken. Such deposits are to be held under the control of the ceding company. Additionally, any securities held under such an arrangement must be investments that the ceding company is allowed to make under the provision of the investment sections of the insurance statutes. Other permissible arrangements include irrevocable trusts or “clean” letters of credit. If the assuming company is not licensed or is not an authorized reinsurer in the domiciliary state of the ceding company or if the reinsurance does not meet required standards, the ceding company must set up a net liability equal to the following:

1. Reserve credits taken including any Interest Maintenance Reserve (IMR) liability adjustment, plus

2. Claim liability credits taken on paid and unpaid (in course of settlement) claims recoverable, plus

3. Other asset increases or liability reductions resulting from amounts recoverable from the assuming company including commissions, expense allowances, modified coinsurance reserve adjustments, experience rating refunds, and estimated incurred but not reported claim liabilities, less

4. Deposits by or funds withheld from the reinsurer, as provided for in the reinsurance treaty, pledged as security for the payment of reinsurance obligations. Such deposits or
funds are typically held by the ceding company or are placed in a trust or custodial agreement. Amounts placed in trust or custodial accounts are held subject to withdrawal by, and under the control of, the ceding insurer, less

5. Amounts of reinsurance recoverables covered by a clean, irrevocable letter of credit issued by a qualified banking institution, less

6. Amounts contractually due the assuming company.

The net liability defined above should never be less than zero for any particular reinsurer. Caution should be exercised in taking credit for items in 4, 5, and 6 above since state requirements vary considerably. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

**Funds Held Under Reinsurance Treaties with Unauthorized Reinsurers**

This liability is for funds deposited by or contractually withheld from unauthorized reinsurers. Please note that the withholding of reinsurance premiums represents only one method of securing net reinsurance liabilities. Letters of credit from or funds escrowed in a financial institution represent two other commonly accepted methods.

15. Chapter 21 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on expense allowances and reinsurance commissions:

**Expense Allowances on Reinsurance**

For reinsurance it is common for the assuming insurer to provide an expense allowance to cover expenses of the ceding insurer. The allowance is frequently nonspecific with respect to premium taxes and other general expenses of the ceding insurer and it is usually combined with and accounted for as part of the commissions on reinsurance assumed or ceded.

The portion of reinsurance expense allowances which represents specific reimbursement of premium taxes should be accounted for as premium tax. Any portion specifically reimbursing general expenses should be accounted for as other general expense. Each should be excluded from commissions and expense allowances on reinsurance assumed or ceded.

**Reinsurance Commission Accounting Practices**

Under current statutory accounting practices and procedures, commissions on direct business, commissions and expense allowances on reinsurance assumed, and commissions and expense allowances on reinsurance ceded are each accounted for separately in the Summary of Operations and on the balance sheet. Accordingly, commissions and expense allowances on reinsurance ceded are reported as income or revenue earned in the Summary of Operations and the balance sheet provision for due and accrued amounts is reported as an asset. This differs from the more customary statutory accounting practice of reporting insurance transactions net of reinsurance in the Summary of Operations and on the balance sheet with reliance upon supporting exhibits for the reinsurance information.


**A. Indemnity Reinsurance**

**Transfer of Risk**

Reinsurance agreements must transfer risk from the ceding company to the reinsurer in order to receive the reinsurance accounting treatment discussed in this chapter. If the terms of the
agreement violate the risk transfer criteria contained herein, i.e., limits or diminishes the transfer of risk by the ceding company to the reinsurer, the agreement shall be accounted for as discussed in the Deposit Accounting section below. In addition, any contractual feature that delays timely reimbursement, violates the conditions of reinsurance accounting.

This paragraph applies to all life and accident and health reinsurance agreements except for yearly renewable term reinsurance agreements and non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance. All reinsurance agreements covering insurance products or similar products of the type identified in A(6) of Appendix A shall follow the guidance for reinsurance accounting contained in this chapter provided the reinsurance agreement (1) transfers significant insurance risk and (2) does not contain any of the conditions set forth in Appendix A. All products not of the type identified in A(6) of Appendix A or covered in the following two paragraphs, shall follow the guidance for reinsurance accounting contained in this chapter provided that the agreement (1) transfers one or more of the risk categories described in A(6) and (2) does not contain any of the conditions set forth in Appendix A. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Yearly renewable term reinsurance agreements that transfer a proportionate share of mortality or morbidity risk inherent in the business being reinsured and do not contain any of the conditions described in Appendix A(2), (3), (4), (8), (9), (10) or (11), shall follow the guidance for reinsurance accounting. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

For non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance agreements, contract terms should be evaluated to assess whether they transfer significant risk to the reinsurer. For example, prepayment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company limits the risk to the reinsurer. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payment to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Reinsurance accounting shall apply to all non-proportional agreements that transfer significant risk and do not contain any provisions that protect the reinsurer from incurring a loss. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Accounting and Reporting of Reinsurance

The obligation of reporting reinsurance in force and of determining unpaid premiums and incurred claims and other balances is generally on the ceding company because it knows the current status of the policies it has written directly and reinsured. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding company and the transmittal of information and its entry on the books of the assuming company. The assuming company shall estimate any material unreported premiums and related costs, since it alone has the responsibility for determining its own financial condition and for preparing accurate financial statements.

The ceding company must report these items in its balance sheet:

1. Credits (deductions) to its policy and claim reserves and unpaid claims;
2. Premiums or other amounts payable on reinsured risks;
3. Amounts recoverable on claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses;
4. Modified coinsurance reserves; and
5. Amounts receivable or payable for funds withheld.
Similarly, in its balance sheet, the assuming company must report:

1. Reserves for reinsurance assumed reduced by any modified coinsurance reserves;
2. Reinsurance premiums receivable or other amounts receivable;
3. Amounts payable for claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses; and
4. Amounts receivable or payable for funds withheld by the ceding company.

While the various balances that a company (ceding or assuming) has with its reinsurance partners will result in a net amount, the proper way to report them is in their separate classifications. The balances of one company shall not be netted against those of any other company. Each reinsurance agreement must be accounted for separately.

Reinsurance Premiums

For all reinsurance arrangements, the assuming company must report premiums under the terms of the reinsurance contract as income and establish any asset or liability consistent with the methods and assumptions used to establish its policy reserves and guidance contained in Chapter 18, Premium Income, of this manual. The ceding company shall reduce premium income by the amounts paid or payable to the reinsurers. The ceding company shall reduce its deferred and uncollected premiums reported as an asset and the assuming company shall record an asset for premiums payable to the reinsurer on those insurance policies with premiums collected on a basis more frequent than annual covered by the reinsurance arrangement. On those insurance policies covered by the reinsurance arrangement with premiums collected annually, the ceding company shall establish a liability and the assuming company shall record an asset for premiums payable to the reinsurer.

Reinsurance Benefit Payments

Policy benefit payments paid or payable by the reinsurer shall be reported in the Summary of Operations and reduces the ceding company’s reported benefit payments. The reinsurer shall establish a liability for its share of any unpaid claim payments and the ceding company shall reduce any policy and contract claim liability with respect to the reinsured policies or establish a receivable for the amount due from the reinsurer for claims paid.

Expenses

The taxes, commissions, and other expenses that will be paid by the assuming company to the ceding company are agreed upon when the reinsurance agreement is negotiated. These items are calculated in accordance with the reinsurance agreement and usually relate to premiums or claims or both. At the statement date, the amount of unpaid expenses is generally based upon the amount of premiums and claims unpaid at that date.

Some coinsurance contracts provide that the assuming company pay to the ceding company a commission that exceeds the first-year premium. In the absence of any guarantees for payment of future premiums (for example, persistency guarantees), these commissions are accounted for on the cash basis. If, however, the ceding company guarantees that premiums will be paid in the future, which, in essence, returns the excess commission, it must record the excess commission as a liability. This liability is then to be released as future premiums are paid to the assuming company. The rate of release is determined in accordance with the anticipated experience and reasonable commission rate for first-year and renewal premiums. Excess commissions such as these are nothing more than a means of financing for the ceding company.

If renewal expense allowances in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, a liability is to be established by the ceding company for the present value of the shortfall. In establishing this liability, assumptions are to be used equal to the applicable statutory reserve...
basis on the business reinsured. Anticipated allocable expenses includes commissions, premium
taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance
expected by the company at the time the business is reinsured.

Experience Refunds

Some reinsurance contracts, generally proportional reinsurance, provide that the reinsurer will
refund an agreed upon portion of its profit to the ceding company. The reinsurance contract will
provide the calculation and the factors to be included.

If the contract provides for experience refunds, the ceding company must record, as an asset, the
amount of the refund receivable as of the statement date, but reduced by any amount that is
contingent upon future experience. The assuming company is also required to record, as a
liability, the amount of the refund calculated at the statement date, but without regard to any
effects that future experience might have.

Credits for Ceded Reinsurance

The credit taken by the ceding company under the coinsurance arrangement is calculated using
the same methodology and assumptions used in determining its policy and claim reserves. It is,
of course, only for the percentage of the risk that was reinsured. Under modified coinsurance, the
reserve credit is reduced by the modco deposit retained by the ceding company. If the company
reinsures on a yearly renewable term basis, it is itself buying insurance for the portion of the
ceded amount at risk. The amount of yearly renewable term reinsurance that is required on a
given policy generally decreases each year as the company’s reserve increases. The net amount
at risk may increase, however, on interest sensitive products such as universal life. The amount
at risk on accident and health yearly renewal term reinsurance will remain level and the
reinsurance premium increases each year.

The reserve credit taken by the ceding company is reported as a reduction to the reserves and
not as an asset of the company. The ceding company’s reserve credit and assuming company’s
reserve for yearly renewable term reinsurance shall be computed as the one year term mean
reserve on the amount of insurance ceded. The ceding company must use the same mortality
and interest bases which were used for valuing the original policy before reinsurance. The credit
may also be computed on a pro rata basis if the result is not materially different from the credit
computed on the mean reserve basis. For all types of reinsurance, the ceding company also
takes credit for other amounts due from the reinsurer such as unpaid claims and claims incurred
but not reported. If contemplated by the reinsurance contract, recognition of related assets and
liabilities must occur (policy loans, due and deferred premiums, etc.).

Non-proportional reinsurance is generally purchased in order to safeguard the company’s
aggregate loss potential. This form of reinsurance is entered into on an annual basis to limit the
claims experience of the company and thereby protect its financial integrity. When the period
of the arrangement exceeds one year, the contract must be carefully reviewed to determine if the
end result more closely follows proportional reinsurance. No reserve credit is taken for non-
proportional reinsurance unless the aggregate attachment point has in fact been penetrated. In
order for a company to reflect reserve credits on a prospective basis, the company will need to
demonstrate that the present value of expected recoveries using realistic assumptions and not
statutory assumptions required for the underlying policy reserves, to be realized from the
reinsurer is in excess of the present value of the reinsurance premiums guaranteed to be paid by
the ceding insurer under the terms of the contract. Because non-proportional reinsurance
aggregates experience, and does not indemnify the ceding insurer for each policy loss, the use of
statutory assumptions underlying the insured policies is inappropriate for determining any reserve
credit to be taken by the ceding insurer. Historical experience, pricing assumptions and asset
shares should be considered in determining if the reinsurer may be reasonably expected to pay
any claims. The reserve credit taken may only reflect these reasonable expectations. This
treatment of non-proportional reinsurance is similar to the way property and casualty (P&C)
reinsurance is considered. This is because these modes of reinsurance more closely follow P&C
indemnification principles than life insurance formula basis, and because these coverages are very similar to excess insurance on P&C products. In determining the appropriate reserve credit, the probability of a loss penetrating to the reinsurer's level of coverage (using reasonable assumptions) must be multiplied by the expected amount of recovery. This is the same as reserve credits on coinsurance where the probability of a claim (i.e., mortality) is multiplied by the expected return (i.e., death benefit). In that the coverage is for aggregate experience, the mortality assumptions underlying any one policy risk is inappropriate to analyze the appropriate credits for non-proportional coverage.

Accounting for Interest Maintenance Reserve (IMR)

The interest-related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR in accordance with the IMR instructions contained in the NAIC Annual Statement Instructions Manual.

Reserves for Reinsurance Assumed

In assuming any insurance risks, the assuming company is required to establish policy reserves that are consistent with its obligations. The reserves it must establish, therefore, are also dependent upon the arrangement of reinsurance that is used. For risks transferred under the reinsurance arrangement, policy and claim reserves must be at least equal to the required reserves calculated using the same methodology and assumptions that would be used if the reinsurer had written the risk directly.

Accounting for Modified Coinsurance Arrangements

When the intent of the parties and the terms of the reinsurance contract are to enter into a modified coinsurance arrangement, the following accounting applies.

Ceding Company

In a modified coinsurance arrangement, the ceding company retains the assets equal to the modified coinsurance reserve. This reserve represents a prepayment of the reinsurer's future obligation. Premiums paid or payable to the reinsurer net of any experience refunds shall result in the reduction of premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding company's reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the Summary of Operations.

Assuming Company (Reinsurer)

Premiums received or receivable by the reinsurer shall increase premium income net of any experience refunds and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations when payable. The statutory policy reserves excludes the modified coinsurance reserve. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the Summary of Operations. The reinsurer's accounting of its obligations shall be consistent with the ceding company's accounting for the transfer of the obligations.

Accounting for Coinsurance With Funds Withheld Arrangements

When the intent of the parties and the terms of the reinsurance contract are to enter into a coinsurance arrangement with funds withheld, the following accounting applies.
Ceding Company

Premiums paid or payable to the reinsurer net of any experience refunds shall reduce premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding company’s reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations as earned. A net reduction to policy reserves shall be taken for the portion of the obligation assumed by the reinsurer. Any amounts withheld by the ceding company shall be recorded as a separate liability. Any interest due or payable on the amounts withheld shall be recorded as interest on indebtedness.

Assuming Company (Reinsurer)

Premiums received or receivable by the reinsurer net of any experience refunds shall increase premium income and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations when payable. The reinsurer shall record its share of the statutory policy reserves attributable to the business identified in the contract. Any funds withheld by the ceding company shall be recorded as an accounts receivable. Any interest earned or receivable on the funds withheld shall be recorded as miscellaneous income.

Uncollectible Reinsurance

The ceding and assuming companies must determine if reinsurance receivables are collectible. To the extent that the amounts are determined to be uncollectible, these amounts shall be charged to operations. Companies must write off uncollectible reinsurance receivables through the accounts previously utilized to establish the receivables.

Unauthorized Reinsurance

If the reinsurer is not authorized to do business, or is not otherwise approved, the reinsurance is considered to be unauthorized. The Model Law on Credit for Reinsurance specifying the conditions under which reinsurance credit may be taken, shall be followed. (For further discussion of the liability for unauthorized reinsurance see Chapter 17).

Gains and Losses on Indemnity Reinsurance

Under an indemnity reinsurance arrangement the ceding company continues to be liable to the policyholders and the reinsurer has no obligations to them except in the case of cut-through agreements. Typically the ceding company will continue to perform all functions in connection with claims and other policyholder services. Gains and losses on indemnity reinsurance are defined as the net experience under the reinsurance contract within a calendar year. Net experience (underwriting gains or loss) includes ceded premiums, claims, expense allowances, reserve adjustments, any IMR liability adjustment and experience refunds and dividends.

Losses that occur in any year of an indemnity reinsurance contract are immediately recognized. For reinsurance of in-force blocks of business, gains that occur in the initial calendar year are accounted for in accordance with Section 4, subsection C of Appendix B.

For indemnity reinsurance agreements entered into for other than in-force blocks of business, the gains and losses are immediately recognized by the ceding and assuming company.

Recaptures and Commutations

A recapture or a commutation of a reinsurance agreement is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement or a portion of the agreement. Reasons for commuting reinsurance agreements often include: perceived financial instability of the reinsurer, inefficiencies associated with the runoff of longer tailed liabilities, or significantly different evaluation of ultimate loss costs. The assumed reserves and reserve credits taken are eliminated.
by the reinsurer and ceding insurer, respectively. The reinsurer and ceding insurer must also
make any required IMR liability adjustment changes. Any net gain or loss is reported in the
Summary of Operations.

Deposit Accounting

To the extent that a reinsurance contract does not, despite its form, provide for sufficient transfer
of risk, amounts paid are to be accounted for and reported as deposits in the NAIC annual and
interim financial statements in the following manner:

1. At the outset of the reinsurance contract the net consideration paid by the ceding
company (premiums less commissions or other allowances) shall be recorded as
a deposit on the ceding company’s books and as a liability on the assuming
company’s books. The deposit may be reported as an asset in the ceding
company’s statement if (a) the assuming company is licensed, accredited or
otherwise qualified in the ceding company’s state of domicile under Section 1 of
the NAIC Model Law on Credit for Reinsurance or (b) there are funds held by or
on behalf of the ceding company which meet the requirements of Section 2 of
that law. Throughout the life of the contract receipts and disbursements shall be
recorded through the deposit/liability accounts. Income and losses shall be
recognized by a party when, according to the terms of the contract, it has earned
the amount and the other party has no recourse to repayment of such amount in
future periods. When the contract is completed, or when there is a loss payment
in excess of the deposit, any difference between consideration and recoveries
shall be recorded as other miscellaneous insurance income or miscellaneous
insurance loss.

2. No deduction shall be made from the policy or claim reserves on the ceding
company’s balance sheet, schedules and exhibits.

3. The assuming company shall record net considerations to be returned to the
ceding company as liabilities.

B. Assumption Reinsurance

A company may sell all or part of a block of insurance business through an assumption
reinsurance agreement. Typically, under an assumption reinsurance arrangement, the
reinsurance contract is intended to effect a novation, thereby to extinguish the ceding company’s
liability to the policyholder. Assumption reinsurance requires that the reinsurer issue assumption
certificates to the existing policyholders and take over responsibility for policyholder services. On
occasion, the reinsurer will contract with the original company to continue to provide such
services on a fee basis or may contract with a third party. Regulatory approval of assumption
reinsurance arrangements is usually required. Approval is also usually required from the
policyholders, who have a predetermined time period in which to accept or reject the reinsurance
transfer. After the deadline has passed, approval is considered implied for all outstanding
responses. For those policyholders that reject the transfer, the reinsurance agreement typically
converts to a indemnity arrangement. Under this circumstance, reinsurance accounting, as
defined earlier in this chapter, is to be followed.

Accounting for Assumption Reinsurance Transactions

Accounting for assumption reinsurance transactions involves all existing assets and liabilities with
respect to the assumed policies. This involves policy reserves, policy loans, net due and deferred
premiums, dividend accumulations, dividend liability, policy claims, advance premiums, unearned
interest on policy loans, etc. The total effect of all of these assets and liabilities is collectively
referred to as net policy liabilities.
Typically, because a block of in-force business has value, the sale transaction will result in a gain to the ceding company. If the policies are somewhat mature and have reasonably large net policy liabilities, the transaction probably will result in a transfer of cash or other assets by the ceding company. In this case, the net policy liabilities released by the ceding company will be greater than the value of the assets transferred. If the policies are young and have very small net policy liabilities, the assuming company may pay some amount in the purchase. The ceding company is to follow accounting for indemnity reinsurance for the policies sold until it has been formally relieved of the legal liability by either consent from the policyholders or when the expiration period for objecting to the transfer has expired. Upon release of the liability or risk, the ceding company shall recognize any gain or loss immediately. The gain or loss shall be the difference between the book value of the assets and liabilities including any unamortized IMR allocated or related to the block of business transferred. Direct and ceded balances are to be eliminated and gains are to be taken into income proportionally as the policyholders approve the transfer or at the end of the response period.

The assuming company is to value the assets acquired at the date of acquisition at their market values, and the reserves are to be established according to statutory requirements based on the benefits in the individual policies reinsured. If the liabilities exceed the assets, the difference represents goodwill that must be amortized using the interest method over the life of the policies, but for a period not to exceed 10 years. If the assets exceed the liabilities, the assuming company shall record a deferred liability and amortize the amount using the interest method over the expected life of the business but not to exceed ten years.

Upon initiation of the assumption reinsurance contract, the ceding and assuming companies are to report all balances reinsured as direct adjustments to the Balance Sheet. Any net gain or loss is reported as miscellaneous income when recognized.

Accounting for Non-economic Assumption Reinsurance Transactions

When the sale, transfer, or reinsurance of an in-force block of business occurs between affiliated companies that is not an economic transaction, the ceding and assuming company shall not recognize any gain or loss. The statutory liabilities and any unamortized IMR shall be transferred from the ceding company to the assuming company without adjustment. The assuming company shall amortize any transferred IMR at the same rate or amount that would have occurred for the ceding company. To the extent that the value of the assets transferred by the ceding company or the net asset value recorded by the assuming company differs from the liabilities including any unamortized IMR, the ceding and assuming company shall defer and amortize their respective differences consistent with the interest method described for non-affiliated transactions.

Effective Date

The revised accounting and reporting practices set forth in this chapter that were adopted on December 4, 1995, shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into or amended on or after January 1, 1996. The revised accounting and reporting practices shall not apply to reinsurance agreements in force on January 1, 1996.

For accounting periods commencing on or after January 1, 1996, agreements which were: (a) entered into on or after January 1, 1996, and which do not transfer risk shall be accounted for as deposits; (b) amended on or after January 1, 1996, and which do not transfer risk shall be accounted for prospectively as deposits with the appropriate reclassification of outstanding reinsurance balances as deposits with no surplus impact; or (c) amended on or after January 1, 1996, a change in accounting principle associated with the revised accounting in this chapter shall be applied prospectively with no adjustment to surplus. Notwithstanding the effective dates noted above, any insurer which has previously been subject to compliance with the Life and Health Reinsurance Agreements Model Regulation or substantially similar regulation shall be guided by the effective date of the regulation.
CHAPTER 24 — APPENDIX A

The contents of this appendix is taken from the Life and Health Reinsurance Agreements Model Regulation.

Section 4. Accounting Requirements

A. No insurer subject to this regulation shall, for reinsurance ceded, reduce liability or establish any asset in any financial statement filed with the Department if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:

1. Renewal expense allowances provided or to be provided to the ceding ins by the reinsurer in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, unless a liability is established for the present value of the shortfall (using assumptions equal to the applicable statutory reserve basis on the business reinsured). Those expenses include commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured;

2. The ceding insurer can be deprived of surplus or assets at the reinsurer’s option or automatically upon the occurrence of some event, such as the insolvency of the ceding insurer, except that termination of the reinsurance agreement by the reinsurer for nonpayment of reinsurance premiums or other amounts due, such as modified coinsurance reserve adjustments, interest and adjustments on funds withheld, and tax reimbursements, shall not be considered to be such a deprivation of surplus or assets;

3. The ceding insurer is required to reimburse the reinsurer for negative experience under the reinsurance agreement, except that neither offsetting experience refunds against current and prior years’ losses under the agreement nor payment by the ceding insurer of an amount equal to current and prior years’ losses under the agreement upon voluntary termination of in force reinsurance by the ceding insurer shall be considered such a reimbursement to the reinsurer for negative experience. Voluntary termination does not include situations where termination occurs because of unreasonable provisions which allow the reinsurer to reduce its risk under the agreement. An example of such a provision is the right of the reinsurer to increase reinsurance premiums or risk and expense charges to excessive levels forcing the ceding company to prematurely terminate the reinsurance treaty;

4. The ceding insurer must, at specific points in time scheduled in the agreement, terminate or automatically recapture all or part of the reinsurance ceded;

5. The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income realized from the reinsured policies. For example, it is improper for a ceding company to pay reinsurance premiums, or other fees or charges to a reinsurer which are greater than the direct premiums collected by the ceding company;

6. The treaty does not transfer all of the significant risk inherent in the business being reinsured. The following table identifies for a
representative sampling of products or type of business, the risks which are considered to be significant. For products not specifically included, the risks determined to be significant shall be consistent with this table.

Risk categories:

(a) Morbidity
(b) Mortality
(c) Lapse
   This is the risk that a policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.
(d) Credit Quality (C1)
   This is the risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that assets will default or that there will be a decrease in earning power. It excludes market value declines due to changes in interest rate.
(e) Reinvestment (C3)
   This is the risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will therefore earn less than expected. If asset durations are less than liability durations, the mismatch will increase.
(f) Disintermediation (C3)
   This is the risk that interest rates rise and policy loans and surrenders increase or maturing contracts do not renew at anticipated rates of renewal. If asset durations are greater than the liability durations, the mismatch will increase. Policyholders will move their funds into new products offering higher rates. The company may have to sell assets at a loss to provide for these withdrawals.

+ – Significant 0 – Insignificant
### RISK CATEGORY

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* LTC = Long Term Care Insurance  
LTD = Long Term Disability Insurance

(7)  (a) The credit quality, reinvestment, or disintermediation risk is significant for the business reinsured and the ceding company does not (other than for the classes of business excepted in Paragraph (7)(b)) either transfer the underlying assets to the reinsurer or legally segregate such assets in a trust or escrow account or otherwise establish a mechanism satisfactory to the commissioner which legally segregates, by contract or contract provision, the underlying assets.

(b) Notwithstanding the requirements of Paragraph (7)(a), the assets supporting the reserves for the following classes of business and any classes of business which do not have a significant credit quality, reinvestment or disintermediation risk may be held by the ceding company without segregation of such assets:

- Health Insurance—LTC/LTD
- Traditional Non-Par Permanent
Traditional Par Permanent
Adjustable Premium Permanent
Indeterminate Premium Permanent
Universal Life Fixed Premium
(no dump-in premiums allowed)

The associated formula for determining the reserve interest rate adjustment must use a formula which reflects the ceding company’s investment earnings and incorporates all realized and unrealized gains and losses reflected in the statutory statement. The following is an acceptable formula:

\[
\text{Rate} = \frac{2(I + CG)}{X+Y-I-CG}
\]

Where:
- \(I\) is the net investment income (Exhibit 2, Line 16, Column 7)
- \(CG\) is capital gains less capital losses (Exhibit 4, Line 10, Column 6)
- \(X\) is the current year cash and invested assets (Page 2, Line 10A, Column 1) plus investment income due and accrued (Page 2, Line 16, Column 1) less borrowed money (Page 3, Line 22, Column 1)
- \(Y\) is the same as \(X\) but for the prior year

Drafting Note: Line references are for the 1992 annual statement. Line references may be deleted or should be updated if regulation is adopted after calendar year 1992. Be aware that annual statement line references may change from year to year.

(8) Settlements are made less frequently than quarterly or payments due from the reinsurer are not made in cash within ninety (90) days of the settlement date.

(9) The ceding insurer is required to make representations or warranties not reasonably related to the business being reinsured.

(10) The ceding insurer is required to make representations or warranties about future performance of the business being reinsured.

(11) The reinsurance agreement is entered into for the principal purpose of producing significant surplus aid for the ceding insurer, typically on a temporary basis, while not transferring all of the significant risks inherent in the business reinsured and, in substance or effect, the expected potential liability to the ceding insurer remains basically unchanged.

CHAPTER 24 — APPENDIX B

B. Notwithstanding Subsection A, an insurer subject to this regulation may, with the prior approval of the commissioner, take such reserve credit or establish such asset as the commissioner may deem consistent with the Insurance Law (or Code), Rules or Regulations, including actuarial interpretations or standards adopted by the Department.

C. (1) Agreements entered into after the effective date of this regulation which involve the reinsurance of business issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding company with the commissioner within thirty (30) days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer’s actuary who signs the financial statement actuarial opinion with respect to valuation of reserves shall consider this regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with this department. The actuary should maintain adequate
documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.

(2) Any increase in surplus net of federal income tax resulting from arrangements described in Subsection C(1) shall be identified separately on the insurer's statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account, page 4 of the Annual Statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the "Reinsurance ceded" line, page 4 of the Annual Statement as earnings emerge from the business reinsured.

{For example, on the last day of calendar year N, company XYZ pays a $20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is $13.2 million ($20 million—$6.8 million) which is reported on the "Aggregate write-ins for gains and losses in surplus" line in the Capital and Surplus account. $6.8 million (34% of $20 million) is reported as income on the "Commissions and expense allowances on reinsurance ceded" line of the Summary of Operations.

At the end of year N+1 the business has earned $4 million. ABC has paid $.5 million in profit and risk charges in arrears for the year and has received a $1 million experience refund. Company ABC’s annual statement would report $1.65 million (66% of [4 million—$1 million—$.5 million] up to a maximum of $13.2 million) on the “Commissions and expense allowance on reinsurance ceded” line of the Summary of Operations, and—$1.65 million on the “Aggregate write-ins for gains and losses in surplus” line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.}

17. The proposed Actuarial Guideline JJJ, which follows, provided further clarification of reinsurance accounting:

Draft:  11/17/95

Adopted by the Life and Health Actuarial (Technical) Task Force on 12/1/95

ACTUARIAL GUIDELINE JJJ

GUIDELINE CONCERNING QUESTIONS AND ANSWERS RELATED TO THE LIFE AND HEALTH REINSURANCE AGREEMENTS MODEL REGULATION

Background

In September 1992 a revision of the Life and Health Reinsurance Agreements Model Regulation was adopted by the NAIC. Since then a number of questions have arisen by regulators regarding its application and interpretation. In early 1994 the Reinsurance Working Group was formed and charged by the Life and Health Actuarial (Technical) Task Force to provide guidance in interpreting provisions of the model regulation. This charge is being met through the completion of this Guideline in the form of a Q&A document which discusses and adds a degree of insight into certain aspects of the regulation. This document is not intended to expand the content of the model regulation. Each state will retain the authority and ability to independently interpret its own regulation. This document gives some insight into the intent of the original drafters of the model regulation and provides interpretive guidance regarding certain of its provisions.
Section 3

Question: Aside from assumption reinsurance, what other type of reinsurance is exempt from the model regulation?

Answer: The model exempts all yearly renewable term (YRT) and certain nonproportional reinsurance arrangements, such as stop loss and catastrophic reinsurance. The purpose behind the exemption of these types of arrangements was because these did not normally provide significant surplus relief and therefore were not the target of this regulation. Users of the regulation should, however, be cautious of any reinsurance arrangements which could be created to misstate a company's true financial position or attempt to circumvent the regulation by artificially labeling an agreement YRT. If a YRT provides incidental reserve credits for the ceding insurer's net amount at risk for the year with no other “allowance” to enhance surplus, or a catastrophic arrangement which takes a reserve credit for actual losses beyond the attachment point or the unearned premium reserve (UPR) of the current year's premium, there will most likely be no regulatory concern. The NAIC Examiners Handbook (Part 5–Reinsurance section) provides significant insight into all reinsurance agreements, whether covered by this regulation or not. Section II(B)(4) provides discussion on a reinsurance agreement's effect on surplus and provides areas of concern to the regulator in determining a bona fide transfer of risk. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance.

Section 4A

Question: What is disallowed in the case of non-complying coinsurance with funds withheld treaties? modified coinsurance treaties?

Answer: The underlying intent of the section is to ensure that a company's financial condition is appropriately stated and not distorted by artificially enhancing surplus through “reinsurance” arrangements that do not fully transfer risks to the reinsurer or which otherwise fail to comply with the standards contained in the regulation. Therefore, all reserve credits, liability reductions or assets established by the ceding insurer that are supported by or conditioned on the treaty should be non-admitted to the extent called for in the regulation for any reinsurance agreement that does not comply with Section 4A.

If a reinsurance agreement is such that one or more of its terms violates or fails to comply with the provisions of the model regulation, a company should not include any liability reduction or any asset recognition in any financial statement. A liability reduction or asset may appear in the financial statement in various forms: reserve credits, receivables or transferred funds.

Funds that have been received or credited by the ceding insurer, such as commissions or other front end allowances, regardless of the name given it, shall not be recognized as a surplus enhancement on the annual statement. If so reported, the entire value of such funds currently reported should be non-admitted.

Both forms of coinsurance, funds withheld and modified coinsurance, have an implicit or explicit reserve credit being taken. A modified coinsurance (modco) deposit is also reflected within the same line as an offset to the reserve credit. This ultimately reflects aggregate reserves being reported as if there were no reinsurance. So long as the modco deposit is for the sole purpose of paying FUTURE claims, the modco deposit may be offset against the implicit reserve credit with no additional penalty (other than the nonadmission of any front end allowance as discussed above) being assessed against the ceding insurer.

With regard to coinsurance with funds withheld, the reserve credit taken will be initially nonadmitted. The funds withheld may serve several purposes. It may be funds withheld which the ceding company owes to the reinsurer as a liability payable, such as the last accounting quarter’s
premium payable. The funds may also be used, similar to modco, to hold funds to be applied against FUTURE claim payments, with the funds having no other liability. To the extent that funds are available solely for paying future claims, such amount may be used to reduce the otherwise nonadmitted reserve credit. Care must be taken that no reduction in the nonadmitted reserve credit be taken when funds serve another purpose, such as being payable to the reinsurer, in addition to the reinsurer’s obligation to pay claims.

An insurer is legally able to enter into contracts with other entities, including other insurers. The provisions of such a contract will be required to be accounted for based on the terms and conditions of the agreement. If the agreement meets the conditions of an acceptable reinsurance arrangement, the ceding insurer is afforded the additional benefit of being able to reduce its otherwise required statutory liabilities by a reserve “credit.” If the agreement does not meet the conditions of this regulation, no reserve credit, whether as an asset or as an offset to liability, may be taken. This treatment does not rescind or otherwise eliminate the existence of the contract. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance for such agreements.

Section 4A(1)

Question: What should be included in the renewal expense allowances with regard to direct expenses? An allocation of salaries? Computer usage? Or just marginal expenses directly related to the business reinsured such as claim payment expenses, postage, etc.? Should the renewal expense allowances cover actual anticipated allocable expenses of a small company in a start-up mode (i.e. high expenses) or should they be based on what expected expenses would be once the company is more mature?

Answer: The primary purpose of the model regulation is to prohibit credit for reinsurance under financial arrangements where the ceding company enters into an agreement for the principal purpose of producing significant surplus aid for the ceding insurer on a temporary basis, while not transferring all of the significant risks inherent in the business being reinsured.

Section 4A(1) implements the purpose of the model by prohibiting credit for reinsurance in certain instances where the ceding insurer is afforded a large ceding commission at the inception of the agreement resulting in a significant increase in surplus only to have the surplus increase be drained away in subsequent periods because renewal expense allowances provided under the agreement are insufficient to cover the direct allocable costs estimated at the time the business is reinsured, which are anticipated to be incurred by the ceding insurer in maintaining the business reinsured.

The model allows an exception to complete disallowance of credit for reinsurance in situations where the ceding insurer reflects a liability for the present value of the shortage between renewal expense allowances provided under the agreement and the direct allocable costs expected in the future by the insurer in maintaining the business reinsured. This liability must be calculated using actuarial assumptions that are consistent with those utilized in the statutory reserve calculation. The expenses to be accounted for in establishing this liability should represent all costs of the ceding insurer in servicing the business that is subject to the agreement.

In determining what the ceding insurer should include in the renewal expenses with regard to direct expenses, there should be an allocation of all renewal expenses anticipated at the time the business is reinsured including salaries, computer usage, postage, etc. This comprehensive calculation should be done regardless of whether a company is in a start-up mode (and experiencing high expenses) or is otherwise more mature but, recognizing that the anticipated expense levels may be estimated, a comparison with pricing assumptions may be considered in determining the reasonableness of such assumptions.

If insurance department staff encounter an agreement that does not comply with Section 4A(1) of the model, this area of non-compliance should be addressed by the posting of a reserve for the present value of the deficiency rather than denial for credit for reinsurance, assuming that no
other area of non-compliance is encountered with the agreement and that the assets received corresponding to the ceding commission are in compliance with other statutes and regulations. For example, the assets received corresponding to the ceding commission must be admissible and not subject to repayment to the reinsurer.

NOTE: Some states have adopted versions of the model regulation that do not allow partial credit when renewal expense allowances are deficient. In those states complete disallowance of reinsurance credit would result for treaties that do not comply with the renewal expense allowance requirement.

Section 4A(2)

Question: With regard to existing business, should the coinsurance reserve percentage or the coinsurance reserve amount not be allowed to increase in a combination coinsurance/modified coinsurance treaty? How would the rule be applicable to the difference between the total reserve and the amount of funds withheld in a coinsurance with funds withheld treaty?

Answer: Section 4A(2) disallows reinsurance credit if the ceding company can be deprived of assets at the reinsurer’s option or automatically upon the occurrence of some event. Thus a provision in a coinsurance with funds withheld treaty that allows the reinsurer to convert the treaty to coinsurance at some later date would be in violation of the model regulation. Although the parties could have entered into a coinsurance agreement at its inception, regulators are concerned that the reinsurer would take assets from the ceding company at a time that would be to the detriment of the ceding company’s policyholders.

Under a combination coinsurance/modified coinsurance (co/modco) arrangement the ceding company and the reinsurer both establish reserves for future claim payments. When a claim becomes payable, the reserves held by each party must be used proportionally to pay the claim. Treaty provisions that adjust the reserves each party holds in lieu of transferring funds owed to the reinsurer are acceptable. However, adjustment of reserves in lieu of payment when funds are owed to the ceding company is a violation of the model regulation since it is a depletion of the ceding company’s assets. This is the case even if the agreement provides for this adjustment at inception and never requires a payment to be owed by the reinsurer. Noncompliance with the model regulation would exist if both the coinsurance amount and the coinsurance percentage (for existing business) were allowed to increase on any settlement date.

Under a coinsurance with funds withheld treaty the reinsurer establishes the entire amount of reserve liability on its share of reinsured policies, but the ceding company withholds assets from the reinsurer, typically in an amount less than the reserves, to offset future obligations. There is no duty on the part of the reinsurer to maintain the book value of the withheld assets at a certain level as there is under co/modco, where the book value of the assets supporting the modco reserves must equal the modco reserves. Provided the withheld assets are not withheld for any purpose other than the payment of future claims, it is not a violation of the model regulation for the reinsurer to require full use of withheld assets for the payment of claims prior to using any other assets owned by the reinsurer.

Section 4A(2) and 4A(5)

Question: Should a reinsurer have a unilateral right to establish underlying cost of insurance rates or credited interest rates for policies that are wholly or partially reinsured?

Answer: No, only the ceding company has the contractual relationship with the insured and the right to set the cost of insurance rates charged policyholders and to set the rates of interest credited to them. However, a representation (but not a warranty) that the ceding company shall vary nonguaranteed elements reinsured in a manner consistent with the ceding company’s documented procedures at the time the agreement was entered into does not violate the requirements of the regulation.
Question: May a reinsurance contract allow the reinsurer to increase the cost of insurance that the ceding company must pay under the treaty?

Answer: So long as the aggregate amounts payable by the ceding company in any settlement period do not exceed the income of the reinsured policies during that period, the treaty's structure would not be in violation of Section A(5) of the model regulation. There is not compliance with Section A(5) if any increases could exceed income.

Question: If a reinsured policy allows the ceding company to guarantee rates of interest to be credited to the policyholder that are greater than those guaranteed by the policy, may a reinsurance contract allow the reinsurer to limit its participation in the credited rate as long as it at least provides for the amount based on the rate guaranteed in the contract?

Answer: Again, so long as there is no possibility that the ceding company will have to make payments for which it is not fully reimbursed, no violation exists. Otherwise, the treaty would not be in compliance with Sections 4A(2) and 4A(5).

Section 4A(7)

Question: Is asset segmentation an acceptable mechanism for legal segregation of assets?

Answer: Generally no. Segmentation involves the allocation of a company's general account investment earnings over several lines of business, or various groups of policies within those lines, such that the performance of one corporate bond, for example, may affect the earnings of several segments within a company. The accounting for the segmentation is largely internal, and the detail of the record-keeping varies from company to company.

The fundamental purpose of the requirement for a reinsurance treaty to employ the use of a segregated asset portfolio (SAP) is that all payments (interest, benefits, allowances, etc.) must be made from the SAP, to eliminate any problems that could arise in determining what asset or assets should be sold, and to avoid disputes in the event of insolvency. Any sale of assets that could affect policies not subject to reinsurance, or policies subject to reinsurance with other reinsurers is problematic.

In addition, auditing the performance of a treaty using traditional segmentation methods would be extremely difficult and prone to disagreement, which could provide a reinsurer with broad leverage to contest amounts due that reinsurer, especially in the event of insolvency or rehabilitation of the ceding company.

It is important to determine that the arrangement in place does in fact transfer all of the risks of the underlying assets supporting the reinsured business to the reinsurer.

Question: If some policies out of a group of similar policies are fully or partially reinsured, and the remainder are not, must the assets supporting the reinsured policies be legally segregated from those supporting the business that is not?

Answer: Yes. Assets supporting policies that are not reinsured may not be part of an SAP.

Question: If a percentage of all policies in a block of business is reinsured, must the company segregate that percentage of the assets supporting the business, or can it segregate all the assets?

Answer: The company may segregate only assets supporting the reinsured portion or the segregated asset portfolio may represent the entire block of business if the reinsured portion is the same for all policies. In the later case, the reinsurer would take its proportionate share of the SAP performance.

Question: If the ceding company cedes a portion of each policy in a block of business to one reinsurer and a portion to another, while retaining some itself, does it have to segregate assets...
separately for each reinsurer, or is it acceptable to have all the assets segregated together with each reinsurer responsible for its portion of the investment risk?

Answer: The ceding company should not segregate assets separately for each reinsurer if the treaties are virtually identical.

Question: At the time assets are legally segregated under a coinsurance with funds withheld treaty, should they be valued at market value, statutory value or some combination?

Answer: The assets should be valued at their statutory admitted assets value.

Question: When the assets are legally segregated, how are the funds withheld payables and receivables reported?

Answer: The payables and receivables are recorded in the same manner as in a funds withheld treaty where the assets are not legally segregated and will usually mirror the value of the funds withheld account. However, the funds withheld account, which reflects the statutory admitted value of the assets in the SAP, will fluctuate, and thus may differ from the reserves on the reinsured business.

Section 4A(8)

Question: Can a company get around this provision if its treaty states that amounts receivable from the reinsurer are payable (due) at a later date?

Answer: No. All amounts receivable from reinsurers are nonadmitted if not paid within 90 days after the end of the period in which the amounts became receivable. The period may not be longer than one quarter (3 months). These amounts include ceding commissions withheld by reinsurers. A ceding commission is an amount that should be paid “up front” and not over time. Furthermore, arguments that the ceding commission was in fact paid but was then deposited with the reinsurer to create a funds withheld from ceding insurer account are unacceptable. Paid means paid.

Question: Does this section permit modco with funds withheld, since this type of reinsurance involves a receivable from the reinsurer?

Answer: Since the funds withheld would be structured as a receivable, the treaty would be in violation of this section.

Section 4A(9)

Question: Can a treaty impose specific controls on the way the ceding company conducts its business? Examples of such controls include the following:

a. Limits on the amount of dividends to be paid to stockholders in any year.
b. Limits on the amount of new business to be issued in any year.
c. Under certain conditions, the right of the reinsurer to replace the ceding company’s investment manager.
d. Restrictions on the types of investments to be held by the ceding company.
e. Increased risk charges under certain circumstances, such as risk based capital ratios falling to a specified level.

Answer: Treaty provisions such as those illustrated above appear frequently. They represent an understanding between the ceding company and the reinsurer at inception of the treaty. The impact and intent of the provisions must be analyzed to determine that they do not relate to general business practices of the ceding company, and are reasonably related to the business being reinsured; provisions that only apply to the business reinsured would generally not be in violation of Section 4A(9).
Section 4A(10)

Question: When, if ever, may references to projections be made in a reinsurance treaty?

Answer: Accounting Requirement A-10 prohibits treaty provisions where "the ceding insurer is required to make representations or warranties about the future performance of the business being reinsured." (It should be noted that "representations or warranties" need not appear in a treaty section entitled "Representations and Warranties" to be considered as such.)

Provisions relating to projections appear in the following forms:

a. Tables of scheduled amounts, typically showing the amount of outstanding surplus relief expected at different times during the life of the treaty, clearly drawn from projections of future profitability of the block of business being reinsured, but not identified as such. This does not represent violations of either Accounting Requirement A-9 or of Accounting Requirement A-10, because they were agreed to at inception of the treaty, and are reasonably related to the business being reinsured. However, the treaty must clearly disclose that these tables do not constitute a guarantee as to the future profitability of the business reinsured.

b. Statements acknowledging that, at inception of the treaty, the reinsurer has received and reviewed projections of the future profitability of the business being reinsured. Such statements do not represent a violation of Accounting Requirement A-9 as long as:

1. there is no language in the treaty implying reliance by the reinsurer on such projections, and
2. language is included stating, in essence, that the reinsurer acknowledges that the ceding insurer is unable to make any guarantees regarding the future profitability of the business being reinsured.

c. Statements requiring that, if "projected results are not met," the reinsurer will take some form of action, such as an increased risk charge. The statements differ from those discussed in Paragraph a. above in that numerical values (drawn form the projections) are not shown in the treaty. Language of this type would be in violation of Accounting Requirement A-10 because it implies a warranty about the future performance of the business being reinsured, on the basis of projections that are not part of the contract.

18. The Annual Statement Instructions require the following disclosures related to reinsurance. Notes 10-12 relate to all reserves including direct, assumed and ceded business. Notes 13-15 relate specifically to reinsurance.

10. Life and Annuities Reserves

Instruction:

A. Describe reserve practices concerning the following:

Waiver of deduction of deferred fractional premiums upon death of insured;
Return of portion of final premium for periods beyond the date of death; and

Note if any surrender value is promised in excess of the reserve as legally computed.

B. State methods employed in the valuation of substandard policies.

C. State the amount of insurance, if any, for which the gross premiums are less than the net premiums according to the standard of valuation required by this state. If not reported in Exhibit B, Section G, Line 10700001, state the amount of reserves and indicate where reported.
D. Have the Tabular Interest (Page 7, Part A, Line 4), Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) and Tabular Cost (Page 7, Part A, Line 9) been determined by formula as described for these lines in the instructions for Page 7 or from the basic data for such items?

E. Describe the method of determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3.

F. Disclose the nature of significant other increases (net) under Page 7, Part B, Line 5.

Illustration:

A. The Company waives deduction of deferred fractional premiums upon death of insured and returns any portion of the final premium beyond the date of death. Surrender values are not promised in excess of the legally computed reserves.

B. Extra premiums are charged for substandard lives for policies issued prior to July 1, 19__, plus the gross premium for a rated age.

Mean reserves are determined by computing the regular mean reserve for the plan at the rated age and holding, in addition, one-half (1/2) of the extra premium charge for the year. Policies issued after July 1, 19__, for substandard lives, are charged an extra premium plus the regular premium for the true age. Mean reserves are based on appropriate multiples of standard rates of mortality.

C. As of December 31, 19__, the Company had $__________ of insurance in force for which the gross premiums are less than the net premiums according to the standard valuation set by the State of ________________. Reserves to cover the above insurance totaled $__________ at year-end and are reported in Exhibit 8, Sections A and B.

D. The Tabular Interest (Page 7, Part A, Line 4) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic date for the calculation of policy reserves).

The Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of reserves and the actual reserves released).

The Tabular Cost (Page 7, Part A, Line 9) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of policy reserves).

E. For the determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3, for each valuation rate of interest, the tabular interest is calculated as one hundredth of the product of such valuation rate of interest times the mean of the amount of funds subject to such valuation rate of interest held at the beginning and end of the year of valuation. The total amount of all such products is entered under Page 7, Part B, Line 3.
F. The details for “Other Increases” (net) under Page 7, Part B, Line 5 are:

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<thead>
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<th>ITEM</th>
<th>1</th>
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<td>5.99</td>
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<td>5.99</td>
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11. Analysis of Annuity Actuarial Reserves and Deposit Liabilities by Withdrawal Characteristics

Instruction:

Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

1. Subject to discretionary withdrawal:
   1.1 – With market value adjustment.
   1.2 – At book value less current surrender charge of 5% or more.
   1.3 – At market value.
   1.4 – Total with adjustment or at market value.
   1.5 – At book value without adjustment (minimal or no charge or adjustment).

2. Not subject to discretionary withdrawal.

3. Total (gross).

4. Reinsurance ceded.

5. Total (net) (3) – (4).

Reconcile the total annuity reserves and deposit fund liabilities amount disclosed in this note to the appropriate sections of Exhibit 8 and Exhibit 10, Line 19, Column 1 of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement.

A. Withdrawal Characteristic Classification Instructions:

1. Classify annual statement liabilities as “subject to discretionary withdrawal with market value adjustments” (1.1 above) where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and:

   (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer. The adjustments either may be based on the insurer’s own investment experience with an assumed duration to the average maturity of the
underlying assets, or related to an index, or related to the maturity date of the liability; or

(b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

2. Classify annual statement liabilities as “subject to discretionary withdrawal at book value less surrender charge” (1.2 above) where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as provided in (4)(d) below.

3. Classify annual statement liabilities as “subject to discretionary withdrawal at market value” (1.3 above) where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk.

4. Classify all other annual statement liabilities as “subject to discretionary withdrawal at book value (minimal or no charge or adjustments)” (1.5 above) where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment; or

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period; or

(c) In a lump sum subject to a fixed surrender charge of less than 5%; or

(d) In a lump sum subject to a surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues; or

(e) All others.

(The one year period from statement date covers both contracts with specified maturity dates on which withdrawal is permitted in accordance with (a) or (b) and contracts providing for a surrender charge which decreases by duration.)

B. Additional Instructions:

1. The annual statement liabilities to be covered by this note are both those actuarial reserves and deposit fund liabilities reported in the Life, Accident & Health Statement and those reported in the Separate Accounts Statement. Include actuarial reserves for annuities (other than disability annuities) and supplementary contracts with life contingencies reported in Exhibit 8; actuarial reserves for annuities, certain supplementary contracts without life contingencies, and deposit fund liabilities for annuities reported in Exhibit 10. Include all annuity actuarial reserves and deposit liabilities reported in the Separate Accounts Statement in this note.

2. Separate each actuarial reserve or deposit fund liability by its withdrawal characteristics, e.g., subject to discretionary withdrawal – with adjustment, etc. If a product contains more than one type of provision for either the individual policyholder or the participant to withdraw funds from the insurer, e.g., routine
withdrawals are at book value, other withdrawals are at market value, separate
the product’s reserves into the appropriate categories. Shared employer group or
jointly underwritten arrangements are to be reported as direct business.

3. Briefly describe the methods of estimation utilized to complete this disclosure if
more precise information was unavailable.

Illustration:

Withdrawal Characteristics of Annuity Actuarial
Reserves and Deposit Liabilities

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Subject to discretionary withdrawal:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1 – With market value adjustment</td>
<td>$_____</td>
<td>_________%</td>
</tr>
<tr>
<td>1.2 – At book value less current surrender charge of 5% of more</td>
<td>_______</td>
<td>_________</td>
</tr>
<tr>
<td>1.3 – At market value</td>
<td>_______</td>
<td>_________</td>
</tr>
<tr>
<td>1.4 – Total with adjustment or at market value</td>
<td>_______</td>
<td>_________</td>
</tr>
<tr>
<td>1.5 – At book value without adjustment (minimal or no charge or adjustment)</td>
<td>_______</td>
<td>_________</td>
</tr>
<tr>
<td>2. Not subject to discretionary withdrawal</td>
<td>_______</td>
<td>_________</td>
</tr>
<tr>
<td>3. Total (gross)</td>
<td>_______</td>
<td>100 %</td>
</tr>
<tr>
<td>4. Reinsurance ceded</td>
<td>_______</td>
<td>_________</td>
</tr>
<tr>
<td>5. Total (net)* (3) – (4)</td>
<td>$_______</td>
<td></td>
</tr>
</tbody>
</table>

*Reconciliation of total annuity actuarial reserves and deposit fund liabilities.

Life & Accident & Health Annual Statement:

6. Exhibit 8, Section B, Total (net) | $ _____ |
7. Exhibit 8, Section C, Total (net) | ________ |
8. Exhibit 10, Line 19, Column 1 | ________ |
9. Subtotal | ________ |

Separate Accounts Annual Statement:

10. Exhibit 6, Line 0299999, Column 2 | ________ |
11. Exhibit 6, Line 0399999, Column 2 | ________ |
12. Page 3, Line 3 | ________ |
13. Subtotal | ________ |
14. Combined Total | $_______ |

12. Premium and Annuity Considerations Deferred and Uncollected

Instruction:

If the company has reported on Page 2, life insurance premiums and annuity considerations
deferred and uncollected on policies in force December 31 of current year, show separately the
amounts and the loading excluded for each of the following lines of business: industrial business,
ordinary new business, ordinary renewal, credit life, group life, and group annuity.
Illustration:

Deferred and uncollected life insurance premiums and annuity considerations as of December 31, 19XX, were as follows:

<table>
<thead>
<tr>
<th>Type</th>
<th>(1) Gross</th>
<th>(2) Net of Loading</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Industrial</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>ii. Ordinary new business</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>iii. Ordinary renewal</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>iv. Credit Life</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>v. Group Life</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>vi. Group Annuity</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>vii. Totals</td>
<td>$__________</td>
<td>$__________</td>
</tr>
</tbody>
</table>

13. Ceded Reinsurance Report

Section 1 – General Interrogatories

A. Are any of the reinsurers, listed in Schedule S as non-affiliated, owned in excess of 10% or controlled, either directly or indirectly, by the company or by any representative, officer, trustee, or director of the company? Yes ( ) No ( ) If yes, give full details.

B. Have any policies issued by the company been reinsured with a company chartered in a country other than the United States (excluding U.S. Branches of such companies) which is owned in excess of 10% or controlled directly or indirectly by an insured, a beneficiary, a creditor or an insured or any other person not primarily engaged in the insurance business? Yes ( ) No ( ) If yes, give full details.

Section 2 – Ceded Reinsurance Report – Part A

A. Does the company have any reinsurance agreements in effect under which the reinsurer may unilaterally cancel any reinsurance for reasons other than for nonpayment of premium or other similar credits? Yes ( ) No ( )

i) If yes, what is the estimated amount of the aggregate reduction in surplus of a unilateral cancellation by the reinsurer as of the date of this statement, for those agreements in which cancellation results in a net obligation of the company to the reinsurer, and for which such obligation is not presently accrued? Where necessary, the company may consider the current or anticipated experience of the business reinsured in making this estimate. $________________

ii) What is the total amount of reinsurance credits taken, whether as an asset or as a reduction of liability, for these agreements in this statement? $________________

B. Does the company have any reinsurance agreements in effect such that the amount of losses paid or accrued through the statement date may result in a payment to the reinsurer of amounts which, in aggregate and allowing for offset of mutual credits from other reinsurance agreements with the same reinsurer, exceed the total direct premium collected under the reinsured policies? Yes ( ) No ( ) If yes, give full details.

Section 3 – Ceded Reinsurance Report – Part B

A. What is the estimated amount of the aggregate reduction in surplus, (for agreements other than those under which the reinsurer may unilaterally cancel for reasons other than
for nonpayment of premium or other similar credits that are reflected in Section 2 above) of termination of ALL reinsurance agreements, by either party, as of the date of this statement? Where necessary, the company may consider the current or anticipated experience of the business reinsured in making this estimate. $______________

B. Have any new agreements been executed or existing agreements amended, since January 1 of the year of this statement, to include policies or contracts which were in force or which had existing reserves established by the company as of the effective date of the agreement? Yes (      ) No (      )

If yes, what is the amount of reinsurance credits, whether an asset or a reduction of liability, taken for such new agreements or amendments? $______________

14. Uncollectible Reinsurance

Instruction:

Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

1. Claims incurred;
2. Claim adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

i. The Company has written off in the current year reinsurance balances due from the companies listed below, the amount of: $_____

which is reflected as:

ii. Losses incurred $_____
iii. Loss adjustment expenses incurred $_____
iv. Premiums earned $_____
v. Other $_____

Company        Amount
XYZ            $_____
ZYX            $_____

15. Commutation of Ceded Reinsurance

Instruction:

Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

1. Claims incurred;
2. Claim adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

Commutation of Reinsurance Reflected in Income and Expenses.
The company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

i. Losses incurred $_____

ii. Loss adjustment expenses incurred $_____

iii. Premiums earned $_____

iv. Other $_____

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
<td>$_____</td>
</tr>
<tr>
<td>ZYX</td>
<td>$_____</td>
</tr>
</tbody>
</table>

**Generally Accepted Accounting Principles**

19. FAS 113 contains the following guidance with respect to reporting assets and liabilities related to reinsurance transactions:

**Reporting Assets and Liabilities Related to Reinsurance Transactions**

14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding company’s liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise’s financial statements. Ceding enterprises shall report estimated reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.

15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of offset exists, as defined in Interpretation 39.

16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

20. FAS 113 contains the following guidance with respect to reinsurance of long-duration contracts:

**Reinsurance of Long-Duration Contracts**

12. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of long-duration contracts requires the reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk as that concept is contemplated in Statement 60 and FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. Statement 97 defines long-duration contracts that do not subject the insurer to mortality or morbidity risks as investment contracts. Consistent with that definition, a contract that does not subject the reinsurer to the reasonable possibility of significant loss from the events insured by the underlying insurance contracts does not indemnify the ceding enterprise against insurance risk.

13. The evaluation of mortality or morbidity risk in contracts that reinsurance policies subject to Statement 97 shall be consistent with the criteria in paragraphs 7 and 8 of that Statement. Evaluation of the presence of insurance risk in contracts that reinsure other long-duration contracts (such as those that reinsurance ordinary life contracts or contracts
that provide benefits related only to illness, physical injury, or disability) also shall be consistent with those criteria.

**Recognition of Revenues and Costs for Reinsurance of Long-Duration Contracts**

25. Amortization of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long duration or short duration. The cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long duration, or over the contract period of the reinsurance if the reinsurance contract is short duration. Determining whether a contract that reinsures a long-duration insurance contract is long duration or short duration in nature is a matter of judgment, considering all of the facts and circumstances. The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts. The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4—Definition of Assets and Admitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force
- Issue Paper No. 51—Life Contracts
- Issue Paper No. 52—Deposit-Type Contracts
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17 - Other Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 21 - Commissions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 24 - Reinsurance (including appendices A and B)
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies, Notes to Financial Statements and Schedule S

**Generally Accepted Accounting Principles**
- FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
- FASB Statement No. 5, Accounting for Contingencies

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 75

Property and Casualty Reinsurance

STATUS
Finalized March 16, 1998

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. Current statutory guidance on the accounting for property and casualty reinsurance is contained in Chapters 7, 8, and 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual).

2. GAAP guidance on the accounting for property and casualty reinsurance is primarily contained in FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113) and Emerging Issues Task Force Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises (EITF 93-6). In certain instances, FAS 113 differs from the current statutory guidance.

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

SUMMARY CONCLUSION

4. This issue paper applies to property and casualty contracts as defined in Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force. The provisions of Chapter 8 of the P&C Accounting Practices and Procedures Manual that relate to reinsurance recoverable on paid losses (included in paragraph 16 of this issue paper) and Chapter 22 of the P&C Accounting Practices and Procedures Manual (Chapter 22) are adopted as the statutory accounting principles for property and casualty reinsurance except as modified in paragraph 5 below. In addition, the Annual Statement Instructions that require reinsurance disclosures in notes 11, 12, 13, 15, 16 and 17 to the Annual Statement are also adopted as statutory accounting principles.

5. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities (Issue Paper No. 76), ceded reinsurance premiums payable may be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right of offset exists.

6. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of Issue Paper No. 76, reinsurance recoverables on paid losses are to be reported as an asset without any available offset.

7. The Property and Casualty Annual Statement Instructions to Schedule F provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if a company’s experience indicates that a higher amount should be provided. The excess reserve over the minimum amount should be charged through the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.
DISCUSSION

8. Statutory accounting for property and casualty reinsurance was recently revised through amendments to Chapter 22. These amendments adopted FAS 113 with modification and EITF 93-6 with modification. This issue paper rejects AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance. As a result, the statutory accounting principles established by this issue paper are generally consistent with GAAP except for the following significant exceptions:

a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be presented as a contra-liability netted against the liability for gross losses and loss adjustment expenses. Under GAAP, these recoverables are reported as assets.

b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums whereas under GAAP, the unamortized portion of the amount paid for prospective reinsurance is recorded as a prepaid asset.

c. The gain created by a retroactive reinsurance contract because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the income statement as a write-in gain in “other income” by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance contract is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid. Under GAAP, gains arising from retroactive reinsurance contracts are deferred and recognized over the settlement period.

d. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers and for certain overdue balances due from authorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.

e. Some reinsurance treaties contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. Chapter 22 and EITF 93-6 require recognition of these adjustable features in the period in which the loss event(s) giving rise to the adjustment occurs. Under EITF 93-6, the asset or liability arising from the adjustable feature may be computed under the assumption that the treaty will be terminated prior to the end of its term if such termination is permitted under the contract and to do so results in a lower asset or liability (“lesser of” provision). Statutory accounting requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the contract, and the impact of early termination may only be considered at the time the contract has actually been terminated.

f. Structured settlements are addressed in Issue Paper No. 65—Property and Casualty Contracts (Issue Paper No. 65). Statutory accounting and FAS 113 are consistent in accounting for structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the payee and the reporting entity has been released from its obligation. FAS 113 distinguishes structured settlement annuities where the claimant is the payee and a legally enforceable release from the reporting entity’s liability is obtained from those where the claimant is the payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from
the purchase of a structured settlement annuity where the reporting entity has not been released from its obligation.

9. Reinsurance recoverables on paid losses and loss adjustment expenses are reported as an asset under both statutory accounting and GAAP. Reinsurance recoverables on unpaid losses and loss adjustment expenses also meet the statutory definition of an asset established in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets; however, this asset will continue to be presented as a contra-liability in statutory financial statements because a change to “gross” presentation would necessitate extensive changes in and restatement of the reporting of ceded reinsurance in schedules and exhibits of the Annual Statement. This “net” presentation is consistent with the reporting of salvage and subrogation established by Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses. Statutory requirements for offsetting and netting are addressed in Issue Paper No. 76.

10. The statutory reporting of amounts paid for prospective reinsurance contracts that have not been amortized to income described in subparagraph 8b is consistent with the “net” reporting discussed in paragraph 9.

11. The statutory accounting for gains and losses resulting from retroactive reinsurance contracts is consistent with the Statement of Concepts which states:

The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance.

12. The statutory requirement to establish a liability, Provision for Reinsurance, for unsecured reinsurance recoverables from unauthorized reinsurers and overdue balances from authorized reinsurers is contained in the Instructions to the Property and Casualty Annual Statement, Schedule F - Part 7 which are adopted in this issue paper as part of Chapter 22. The Schedule F provision for reinsurance was maintained as part of statutory accounting as an added measure of conservatism consistent with the Statement of Concepts. Maintaining this conservatism was deemed appropriate as there is no other apparent independent measure of the adequacy of the estimates. Maintaining this requirement is in contrast to the elimination of the excess statutory reserve in Issue Paper No. 65. It was determined that sufficient information is available to regulators regarding the adequacy of reserves such that the additional conservatism provided by the excess statutory reserve is no longer justified. Paragraph 7 of this issue paper requires that any portion of reinsurance recoverables deemed to be uncollectible as a result of a reporting entity’s experience being higher that the amounts provided by the minimum Schedule F provision shall be written off through a charge to operations, whereas current statutory accounting would require any additional amount to be added to the Schedule F provision resulting in a direct charge to surplus. This change was made to reflect known losses as charges to operations as opposed to direct charges to surplus.

13. Statutory accounting requires the calculation related to adjustable features to be computed based on experience to date because, from a regulatory standpoint, it is improper to recognize the favorable impact of early termination of the contract until such time as the contract is actually terminated.

14. Ceded reinsurance premiums payable are no longer deducted from agents’ balances and uncollected premiums because this payable meets the definition of a liability as established in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets and it does not meet the criteria for offsetting under the provisions of Issue Paper No. 76.

Drafting Notes/Comments
- Reinsurance for life and accident and health contracts is addressed in Issue Paper No. 74—Life and Accident and Health Reinsurance.
Structured settlements for property and casualty insurers are addressed in Issue Paper No. 65—
and Casualty Contracts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
15. Chapter 7 of the P&C Accounting Practices and Procedures Manual, Agents’ Balance or Uncollected Premiums, provides the following guidance on ceded premiums payable:

Ceded Reinsurance Premiums Payable

Ceded reinsurance premiums payable are those premiums that are due to other insurance companies for coverages purchased to reduce the ceding company’s liability. Ceded reinsurance premiums payable are deducted from agents’ balances or uncollected premiums in the balance sheet. (See Chapter 22 - Reinsurance.)

16. Chapter 8 of the P&C Accounting Practices and Procedures Manual provides the following guidance on reinsurance recoverable on paid losses:

(f) Funds held or deposited with reinsured companies, whether they are premiums withheld for unearned premium and outstanding loss reserves or advances for loss payments, are admitted assets provided they do not exceed the liabilities they secure and provided the reinsured is solvent. Those funds which are in excess of the liabilities, and any funds held by insolvent reinsureds, should be nonadmitted.

(h) Reinsurance recoverable on loss payments is an admitted asset. Unauthorized reinsurance is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue on authorized companies will be reflected as a liability. (See Chapter 22 - Reinsurance.)

17. The guidance for calculating the penalty for unauthorized reinsurance and the penalty for overdue balances from authorized reinsurers is contained in the Annual Statement Instructions.

18. The current statutory accounting for property and casualty reinsurance is contained in the P&C Accounting Practices and Procedures Manual, Chapter 22, Reinsurance. Chapter 22 provides the following guidance with respect to the determination of whether a reinsurance contract qualifies for reinsurance accounting:

Reinsurance Contracts Must Include Transfer of Risk

The essential ingredient of a reinsurance contract is the shifting of risk. The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer (i.e., reinsured company), not only in form but in fact, against loss or liability by reason of the original insurance. Unless the so-called reinsurance contract contains this essential element of risk transfer, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer.

Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous - the possibility of adverse events occurring is outside the control of the insured.

Determining whether a contract with a reinsurer provides indemnification against loss or liability (transfer of risk) relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding company and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of
insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

Indemnification of the ceding company against loss or liability relating to insurance risk in reinsurance requires both of the following:

1. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.

2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Implicit in this condition is the requirement that both the amount and timing of the reinsurers payments depend on and directly vary with the amount and timing of claims settled by the ceding company. Contractual provisions that delay timely reimbursement to the ceding company would prevent this condition from being met.

The ceding company's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate.

Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in the above paragraph, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding company shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. In this narrow circumstance, the reinsurers economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding company on the reinsured portions of the underlying insurance contracts, so that the reinsurers exposure to loss is essentially the same as the insurers.

Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurers payment to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurers reimbursement to the ceding company should be closely scrutinized.

19. The effective date for adopting the accounting and reporting requirements outlined in paragraph 18 are contained in Chapter 22 as follows:
Effective Date: Transition Rule

The revised accounting and reporting practices set forth in this chapter that were adopted on September 18, 1994 shall be effective for all accounting periods beginning on or after January 1, 1995 and shall apply to: (a) reinsurance contracts entered into, renewed, or amended on or after January 1, 1994, (an amendment is any revision or adjustment of contractual terms, but the payment of premiums or reimbursement of losses recoverable under the contract shall not constitute an amendment); and (b) reinsurance contracts in force on January 1, 1995 which cover losses occurring or claims made on or after that date on policies reinsured under such contracts.

The revised accounting and reporting provisions shall not apply to: (a) reinsurance contracts which cover only losses occurring or claims made before January 1, 1994 and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and (b) reinsurance contracts that expired before, and were not renewed or amended after, January 1, 1995.

Previously reported amounts relating to contracts to which these revised accounting practices are not applicable shall not be restated. However, for accounting periods commencing on and after January 1, 1995, balances relating to contracts which were entered into, renewed or amended on or after January 1, 1994 and which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption "Reinsurance Contracts Must Include Transfer of Risk".

Insurers may elect to comply with these revised accounting practices for accounting periods commencing before January 1, 1995.

20. Chapter 22 requires the following accounting for reinsurance contracts that do not qualify for reinsurance accounting (i.e., do not transfer insurance risk):

To the extent that a reinsurance contract does not, despite its form, transfer both components of insurance risk, all or part of the contract shall be accounted for and reported as deposits in the NAIC annual and interim financial statements in the following manner:

1. At the outset of the reinsurance contract the net consideration paid by the ceding company (premiums less commissions or other allowances) shall be recorded as a deposit on the ceding company's books and as a liability on the assuming company's books. The deposit may be reported as an admitted asset in the ceding company's annual statement (as a write-in item for other than invested assets) if (a) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile under Section 1 of the NAIC Model Law on Credit for Reinsurance or (b) there are funds held by or on behalf of the ceding company which meet the requirements of Section 2 of that law. Throughout the life of the contract receipts and disbursements shall be recorded through the deposit/liability accounts. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other income or loss.

2. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company's balance sheet, schedules and exhibits.

3. The assuming company shall record net consideration to be returned to the ceding company as liabilities.

21. Chapter 22 requires the following accounting for reinsurance contracts that qualify for reinsurance accounting (i.e., transfer insurance risk). The guidance for retroactive reinsurance contracts was revised by the Property Casualty Reinsurance Study Group at its December 13, 1995 meeting. This
guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.

**Accounting for Reinsurance**

Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which wrote the underlying policy.

Accounting for reinsurance depends on whether the contract is considered prospective or retroactive. Prospective reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

The distinction between prospective and retrospective reinsurance contracts is based on whether the contract reinsures future or past insured events covered by the underlying insurance policies. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance contract. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract. (However, a reinsurance contract that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance contract.)

It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the contract is domiciled outside the U.S. and is not affiliated with such reinsurer, if a contract entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and must be accounted for as a retroactive reinsurance contract. This presumption shall not apply to: (a) facultative reinsurance contracts; nor to (b) reinsurance contracts with more than one reinsurer which are signed by the lead reinsurer (i.e. the reinsurer setting the terms of the contract for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance contract; nor to (c) reinsurance contracts with more than one reinsurer (whether signed by the lead reinsurer or not) which were entered into, renewed or amended on or before December 31, 1996, and which were not renewed or amended after that date) if reinsurers representing more than 50% of the capacity on the contract have signed cover notes, placement slips or similar documents describing the essential terms of coverage and exclusions within nine months after the commencement of the policy period covered by the reinsurance arrangement.

When practicable, prospective and retroactive provisions included within a single contract shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single contract is impracticable, the contract shall be accounted for as a retroactive contract provided the conditions for reinsurance accounting are met.
Accounting for Prospective Reinsurance Contracts

Amounts paid for prospective reinsurance that meets the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current periods statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, reinsurance recoverables on loss and loss adjustment expense payments, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

Accounting for Retroactive Reinsurance Contracts

Certain reinsurance contracts which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the contract. Due to potential abuses involving the creation of surplus to policyholders, and the distortion of underwriting results, a special accounting treatment for such agreements is warranted.

Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for and reported in the following manner:

1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.

2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.

3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as “retroactive reinsurance reserve ceded or assumed”, recorded as a contra-liability by the ceding company and as a liability by the assuming company.

4. The ceding company must, by write-in item on Page 3, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as “special surplus from retroactive reinsurance account”.

5. The surplus gain from any retroactive reinsurance may not be classified as unassigned funds [considered earned surplus] until such time as the actual retroactive reinsurance-recovered is in excess of the consideration paid.

6. The “special surplus from retroactive reinsurance account” for each respective retroactive reinsurance contract shall be reduced at the time the ceding company begins to recover funds from the assuming company in amounts exceeding the consideration paid by the ceding company under such agreement, or adjusted as provided in paragraph 10 below.

7. For each agreement, the reduction in the “special surplus from retroactive reinsurance” account must be limited to the lesser of:

   (a) the actual amount recovered in excess of consideration paid; or
(b) the initial surplus gain resulting from the respective retroactive reinsurance contract.

Any remaining balance in the “retroactive reinsurance reserve ceded or assumed”, account derived from any such agreement must be returned to unassigned funds upon elimination of all policy obligations subject to the retroactive reinsurance contract.

8. The ceding company shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on Page 4, to be identified as “Retroactive Reinsurance Gain” and included under “Other Income” in the Underwriting and Investment Exhibit Statement of Income.

9. The assuming company shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 8., as a write-in item on Page 4, to be identified as Retroactive Reinsurance Loss and included under Other Income in the Underwriting and Investment Exhibit Statement of Income.

10. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs 8. and 9., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The “Special Surplus from Retroactive Reinsurance Account” write-in entry on Page 3 and the pertinent entry in the Notes to the Financial Statement shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The “Special Surplus from Retroactive Reinsurance Account” write-in entry must be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to Unassigned Funds) only when cash recoveries from the assuming company exceed the consideration paid by the ceding company as respects such retroactive reinsurance transaction.

11. Each retroactive reinsurance contract shall be included in the Notes to Financial Statements relating to “Ceded or Assumed Unpaid Loss and Loss Adjustment Expenses”.

12. The consideration paid for a retroactive reinsurance contract shall be reported as a decrease in Exhibit 3 ledger assets by the ceding company and as an increase in Exhibit 3 ledger assets by the assuming company (as a write-in item).

(For an illustration of ceding company accounting entries see Question 33 in Appendix A.)

This procedure regarding accounting for retroactive reinsurance contracts shall not apply to the following types of contracts (which shall be accounted for as prospective reinsurance contracts):

1. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

2. Novations, i.e. (a) transactions in which the original direct insurer’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (b) transactions in which the original assuming company’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated, provided that (i) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (ii) the accounting for
the original reinsurance agreement will not be altered from retroactive to prospective.

3. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business; or

4. Intercompany reinsurance contracts, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction.

Except for its accounting and reporting provisions, this procedure regarding retroactive reinsurance shall not apply to transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation or receivership with written approval of the ceding company’s domiciliary commissioner.

Retroactive reinsurance contracts resulting in surplus gain to the ceding company (with or without risk transfer) entered into between affiliates or between insurers “under common control” (as those terms are defined in the NAIC Model Insurance Holding Company Regulatory Act) shall be reported in annual and interim statements as follows:

1. The consideration paid by the ceding company shall be recorded as a deposit and reported as a non-admitted asset in Exhibit 1; and

2. No deduction shall be made from loss and loss adjustment expense reserves on the ceding company’s balance sheet, schedules and exhibits.

Required Terms for Reinsurance Contracts

In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed for reinsurance recoverable in annual or interim statements required to be filed by the ceding company where the agreement was entered into after the effective date of these requirements unless each of the following conditions is satisfied:

1. The contract must contain an acceptable insolvency clause.

2. Recoveries due the ceding company must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding company.

3. The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly, from the reinsurer to the ceding company or from the ceding company to the reinsurer.

4. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis. The report of premiums and losses shall set forth the ceding company’s total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding company and reinsurer will be recorded and reported on a basis consistent with this manual.

5. With respect to retroactive reinsurance contracts the following additional conditions apply. The consideration to be paid by the ceding company for the retroactive reinsurance must be a sum certain stated in the agreement. Direct or indirect compensation to the ceding company or reinsurer is prohibited. Any provision for subsequent adjustment on the basis of actual experience in regard to policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a retroactive reinsurance transaction, except that
provision may be made for the ceding company’s participation in the reinsurer’s ultimate profit, if any, under the agreement. A retroactive reinsurance contract may not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding company.

Characteristics of Reinsurance Contracts

Each reinsurance contract may be individually drafted. Commonly included contract provisions that may affect accounting practices include:

1. Reporting responsibility of the ceding insurer. Should be clearly spelled out both as to details required and time schedules.

2. Payment terms. Time schedules, currencies intended and the rights of the parties to withhold funds should be established.

3. Payment of premium taxes. Customarily the responsibility of the ceding company, a recital of nonliability of the reinsurer may be found.

4. Termination. May be on a “cut-off” or “run-off” basis. A “cut-off” provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A “run-off” provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the term of the policy expires.

5. Insolvency clause. Should provide for the survival of the reinsurer’s obligations in the event of insolvency of the ceding company, without diminution because of the insolvency.

Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the insurer nor grounds for retroactive revocation or retroactive cancellation of any contracts of the insurer.

Reinsurance Assumed

The segregation of premiums, losses and expenses arising from reinsurance assumed transactions is required for the Underwriting and Investment Exhibit of the annual statement.

Non-proportional assumed reinsurance transactions should be included in the reinsurance lines of business in the annual statement under four subcategories while all proportional reinsurance (first dollar pro-rata reinsurance) must be allocated to the appropriate lines of business.

Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as “Agents’ balances or uncollected premiums”. Where the ceding insurer withholds premium funds pursuant to the terms of the reinsurance contract, such assets should be shown by the assuming company as “Funds held by or deposited with reinsured companies”. Reinsurance premiums more than 90 days overdue should not be included as receivable except (a) to the extent the assuming insurer maintains unearned premium and loss reserves as to the ceding insurer, under normal principles of offset accounting, or (b) where the ceding insurer is licensed and in good standing in assuming insurer’s state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the contract stood on the date of execution); in the absence of a specific contract date, reinsurance premiums will be deemed due thirty (30) days after the date on which (1) notice or demand of premium due is provided to the ceding insurer or (2) the assuming insurer books the premium (See Chapter 9 - Nonadmitted Assets).

A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding insurer and the transmittal of information and its entry on the books of the assuming
company. Assuming companies shall estimate such unreported premiums and related costs to
the extent necessary to prevent material distortions in the loss development contained in the
assuming company’s annual statement schedules where calendar year premiums are compared
to accident year losses.

Amounts payable by reinsurers on losses are generally classified in the annual statement as
unpaid losses. Assumed reinsurance payable on paid losses should be classified as a separate
liability item on the balance sheet. IBNR losses on assumed reinsurance business are netted with
ceded losses on the balance sheet but are shown separately by annual statement line of
business in the Underwriting and Investment Exhibit.

Reinsurance Ceded

The Underwriting and Investment Exhibit of the annual statement presents segregated data on
the premiums, losses and expenses from reinsurance ceded transactions in a manner similar to
reinsurance assumed.

Ceded reinsurance transactions should be included in the annual statement line of business
which relates to the direct or assumed transactions creating the cession or retrocession.

Premiums due reinsurers ("ceded balances payable") are shown as contra assets contained in
"Agents' balances or uncollected premiums." Amounts that are withheld by the ceding company
from sums that would otherwise be payable under the reinsurance contract are reportable as
"Funds held by company under reinsurance treaties."

Adjustable Feature/Retrospective Rating

Reinsurance treaties may provide for adjustment of commission, premium, or amount of
coverage, based on loss experience. Examples are:

1. Commission Adjustments:

   Contingent or Straight Profit—The reinsurer returns to the ceding company a
   stipulated percentage of the profit produced by the business assumed from the
   ceding insurer. Profit may be calculated for any specified period of time, but the
   calculation is often based on an average over a period of years.

   Sliding Scale—A provisional rate of commission is paid over the course of the
   treaty, with a final adjustment based on the experience of the business ceded
   under the treaty.

   An accrual shall be maintained for these adjustable features based upon the
   experience recorded for the period.

2. Premium Adjustments:

   The initial provisional or deposit premium is recalculated retrospectively, based
   on loss experience under the treaty during a specified period of time; the
   calculation is often based on an average over a period of years.

   If the reinsurance treaty incorporates an obligation on the part of the ceding
   company to pay additional premium to the assuming company based upon loss
   experience under the treaty, a liability in the amount of such additional premium
   shall be recognized by the ceding company during the accounting period in
   which the loss event(s) giving rise to the obligation to pay such additional
   premium occur(s). The assuming company shall recognize an asset in the same
   amount.
If the reinsurance treaty incorporates an obligation on the part of the assuming company to refund to the ceding company any portion of the consideration received by the assuming company based upon loss experience under the treaty, an asset in the amount of any such refund shall be recognized by the ceding company during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The assuming company shall recognize a liability in the same amount.

3. Adjustments in the Amount of Coverage:

The amount of coverage available for future periods is adjusted, upward or downward, based on loss experience under the treaty during a specified period of time.

If the reinsurance treaty incorporates a provision under which the reinsurance coverage afforded to the ceding company may be increased or reduced based upon loss experience under the treaty, an asset or a liability shall be recognized by the ceding company in an amount equal to that percentage of the consideration received by the assuming company which the increase or reduction in coverage represents of the amount of coverage originally afforded. Such asset or liability shall be recognized during the accounting period in which the loss event(s) (or absence thereof) giving rise to the increase or decrease in reinsurance coverage occur(s), and shall be amortized over all accounting periods for which the increased or reduced coverage is applicable. The term “consideration” shall mean, for this purpose, the annualized deposit premium for the period used as the basis for calculating the adjustment in the amount of coverage to be afforded thereafter under the treaty.

Effective Date

The accounting and reporting provisions set forth in paragraphs 1, 2 and 3 above shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance contracts entered into, renewed or amended on or after January 1, 1994.

Commissions

Commissions payable on reinsurance assumed business should be included as an offset to “Agents” Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business should be included as an offset to “Ceded Reinsurance Balances Payable”. (See Chapter 18 - Commissions.)

If the ceding commission paid under a non-proportional reinsurance contract exceeds the anticipated acquisition cost of the business ceded, the ceding company shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized pro rata over the life of the reinsurance contract.

Those reinsurance contracts drafted in form as pro rata but which, in fact, contain per loss deductibles to be retained by the ceding carrier shall be considered non-proportional for the purposes of the paragraph above.

Provision for Reinsurance

The liability “Provision for Reinsurance” is reflected on page three of the Annual Statement, and the change between years is recorded as a gain or loss directly to surplus.

The details of this calculation can be found in Schedule “F-Part 7” of the Annual Statement. The appropriate instructions for calculating this liability can be found in the Instructions to the Annual Statement.
This provision is calculated separately for unauthorized and authorized companies in Schedule F. An authorized reinsurer is one that is licensed, accredited or approved by the ceding insurers state of domicile; an unauthorized reinsurer is not so licensed, accredited or approved.

Disputed Items

Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance contract or may even attempt to nullify an entire treaty. A ceding insurer, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. The Annual Statement Instructions require notification of a dispute by a formal written communication from the reinsurer denying the validity of coverage. Additionally, the “Notes to Financial Statements” require footnote disclosure of material amounts and the status of disputed items. Furthermore, a ceding insurer may take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

Commutations

A commutation of a reinsurance contract is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement.

Reasons for commuting reinsurance contracts often include: (1) perceived financial instability of the reinsurer, (2) inefficiencies associated with the runoff of longer tailed liabilities, (3) significantly different evaluation of ultimate loss costs or (4) the reinsurers withdrawal from the reinsurance marketplace.

In commutation agreements, the present value of the reinsurers estimated ultimate losses are paid by the reinsurer to the ceding insurer. The ceding insurer immediately establishes the ultimate loss reserve as its liability and the cash received as a negative paid loss, thus creating a reduction in policyholders surplus equal to the difference between the ultimate and present value of the loss reserve.

The reinsurer, on the other hand, has eliminated a loss reserve carried at ultimate cost for a cash payout calculated at present value. The result is an increase in policyholders surplus equal to the difference between the ultimate and present value of the loss reserves.

Committed balances must be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded.

Uncollectible Reinsurance

Uncollectible reinsurance balances must be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded.

22. Chapter 22 requires the following disclosures with respect to reinsurance. The guidance for retroactive reinsurance contracts was revised by the Property Casualty Reinsurance Study Group at their December 13, 1995 meeting. This guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.

Reporting of Reinsurance Transactions

Ceded reinsurance disclosures in the Notes to Financial Statements of the annual statement indicates the impact on the insurers surplus if all its reinsurance were canceled. The effect of return commissions, sliding scale commissions, as well as minimum and maximum commissions, is required to be calculated and then measured as factors reducing surplus.

Portfolio reinsurance is the transfer of the entire liability of an insurer for in force policies or outstanding losses, or both, as respects a described segment of the insurers business. Loss
portfolio transfers are to be accounted for as retroactive reinsurance which is discussed earlier in this chapter.

A specific interrogatory requires information on reinsurance of risk accompanied by an agreement to release the reinsurer from liability, in whole or in part, from any loss that may occur on the risk or portion thereof.

A commonly accepted practice among affiliated insurers is the sharing of underwriting results (“pooling”) in accordance with predetermined ratios. This is normally accomplished by a procedure whereby all affiliated insurers reinsure their direct business with the major insurers. Business is then retroceded to the affiliates so that each member of the group receives its predetermined share of the gross group business.

Detailed disclosure of certain reinsurance transactions is required in various notes to financial statements. These include retroactive reinsurance, unsecured reinsurance recoverables, reinsurance recoverables in dispute, write off of uncollectible reinsurance, and reinsurance commutations.

23. Chapter 22 provides the following guidance on the National Flood Insurance Program:

National Flood Insurance Program

This program was created by the Federal Emergency Management Agency (FEMA) and is designed to involve private insurers in a “write-your-own” (WYO) flood insurance program financially backed by FEMA at no risk to the insurer. To become a participating WYO company, the insurer signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

Premium rates are set by FEMA. The WYO participating companies write the flood insurance coverage qualifying for the program on their own policies, perform their own underwriting, premium collections, claim payments, administration, and premium tax payments for policies written under the program.

Monthly accountings are made to FIA and participants are allowed to draw upon FEMA letters of credit for deficiencies of losses, loss expenses and administrative expenses in excess of premiums, subject to certain percentage limitations on expenses.

For purposes of statutory reporting in the WYO participating insurers’ annual statements, balances due from or to FEMA should be treated as ceded reinsurance balances receivable or payable in Schedule F, FEMA should be identified as the reinsurer and assigned the NAIC Company Code 46990.

24. The Annual Statement Instructions require the following disclosures related to reinsurance:

11. Unsecured Reinsurance Recoverables

Instruction:

If the company has with any individual reinsurers, authorized or unauthorized, an unsecured aggregated recoverables losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium that exceeds 3% of the company’s policyholder surplus, list each individual reinsurer and the unsecured aggregated recoverable pertaining to that reinsurer. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting company, and the total unsecured aggregate recoverables for the entire group.
Include: The NAIC group code number, where appropriate, and the Federal Employer Identification Number for each individual company.

12. Reinsurance Recoverable in Dispute

Instruction:

Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified in the schedule if the amounts in dispute from any company (and/or affiliate) exceed 5% of the ceding company’s policyholders surplus or if the aggregate of all disputed items exceeds 10% of the ceding company’s policyholder surplus. “Notification” means a formal written communication from a reinsurer denying the validity of the coverage.

Illustration:

<table>
<thead>
<tr>
<th>Name of Reinsurer</th>
<th>Total Amount in Dispute (Including IBNR)</th>
<th>Notification</th>
<th>Arbitration</th>
<th>Litigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A - Reinsurer</td>
<td>$10,000</td>
<td>$10,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B - Reinsurer</td>
<td>$20,000</td>
<td>$10,000</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>C - Reinsurer</td>
<td>$30,000</td>
<td></td>
<td>$30,000</td>
<td></td>
</tr>
</tbody>
</table>

13. Reinsurance Assumed and Ceded

a. Instruction:

Report the maximum amount of return commission which would have been due reinsurers if they or you had canceled all of your company’s reinsurance or if you or a receiver had canceled all of your company’s insurance assumed as of the end of the period covered by this annual statement with the return of the unearned premium reserve. Equity amounts should be computed by applying the fixed or provisional commission rate for each contract to the unearned premium reserve. Line (iii) of Column 5 plus Line (iv) must equal Page 3, Column 1, Line 9.

Illustration:

<table>
<thead>
<tr>
<th>ASSUMED REINSURANCE</th>
<th>CEDED REINSURANCE</th>
<th>NET</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Affiliates</td>
<td>$_____ $_____</td>
<td>$_____ $_____</td>
</tr>
<tr>
<td>ii. All Other</td>
<td>_____ _____</td>
<td>_____ _____</td>
</tr>
<tr>
<td>iii. TOTAL</td>
<td>$_____ $_____</td>
<td>$_____ $_____</td>
</tr>
<tr>
<td>iv. Direct Unearned Premium Reserve</td>
<td>$_____</td>
<td></td>
</tr>
</tbody>
</table>
b. **Instruction:**

Additional or return commission predicated on loss experience or on any other form of profit sharing arrangements in this annual statement as a result of existing contractual arrangements are accrued as follows:

**Illustration:**

<table>
<thead>
<tr>
<th>REINSURANCE</th>
<th>(1) DIRECT</th>
<th>(2) Assumed</th>
<th>(3) Ceded</th>
<th>(4) NET</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Contingent Commission</td>
<td>______</td>
<td>______</td>
<td>______</td>
<td>______</td>
</tr>
<tr>
<td>ii. Sliding Scale Adjustments</td>
<td>______</td>
<td>______</td>
<td>______</td>
<td>______</td>
</tr>
<tr>
<td>iii. Other Profit Commission Arrangements</td>
<td>______</td>
<td>______</td>
<td>______</td>
<td>______</td>
</tr>
<tr>
<td>iv. TOTAL</td>
<td>$ ______</td>
<td>$ ______</td>
<td>$ ______</td>
<td>$ ______</td>
</tr>
</tbody>
</table>

c. **Instruction:**

Disclose all contracts of reinsurance covering losses that have occurred prior to the inception of the contract that have not been accounted for in conformity with the instructions contained in the NAIC *Accounting Practices and Procedures* manual, Chapter 22.

**Illustration:**

All contracts of reinsurance covering losses that have occurred prior to the inception of the contract have been accounted for in conformity with the instructions contained in the NAIC *Accounting Policies and Procedures* manual, Chapter 22, except for the following:

15. **Uncollectible Reinsurance**

**Instruction:**

Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the names or names of the reinsurer(s):

1. Losses incurred;
2. Loss adjustment expenses incurred;
3. Premiums earned;
4. Other.

**Illustration:**

Uncollectible Reinsurance Balances Written Off Through Income and Expense

The Company has written off in the current year reinsurance balances due (from the companies listed below) in the amount of: $________, which is reflected as:

<table>
<thead>
<tr>
<th>Classification</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Losses incurred</td>
<td>$________</td>
</tr>
<tr>
<td>ii. Loss adjustment expenses incurred</td>
<td>$________</td>
</tr>
<tr>
<td>iii. Premiums earned</td>
<td>$________</td>
</tr>
<tr>
<td>iv. Other</td>
<td>$________</td>
</tr>
</tbody>
</table>
16. Commutation of Ceded Reinsurance

**Instruction:**

Describe the commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

i. Losses incurred $ __________
ii. Loss adjustment expenses incurred $ __________
iii. Premiums earned $ __________
iv. Other $ __________

**Illustration:**

Commutation of Ceded Reinsurance

The Company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

i. Losses incurred $ __________
ii. Loss adjustment expenses incurred $ __________
iii. Premiums earned $ __________
iv. Other $ __________

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
<td>$ _______</td>
</tr>
<tr>
<td>ZYX</td>
<td>$ _______</td>
</tr>
</tbody>
</table>

17. Retroactive Reinsurance

**Instruction:**

The following shall be completed for all retroactive reinsurance contracts that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. Transactions utilizing “Deposit Accounting” shall not be reported in this note.

The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance contract and shall utilize this number for as long as the contract exists. The summary (aggregate of all retroactive reinsurance contracts) is to be reported in the form below. For further guidance, refer to Chapter 22 of the NAIC *Accounting Policies and Procedures* manual. Analysis in a similar format on individual retroactive reinsurance contracts may be necessary upon request.
As:

A. Reserves Transferred:
   1. Initial Reserves $ __________ $ __________
   2. Adjustments - Prior Year(s) ___________ ___________
   3. Adjustments - Current Year ___________ ___________
   4. Total $ __________ $ __________

B. Consideration Paid or Received
   1. Initial $ __________ $ __________
   2. Adjustments - Prior Year(s) ___________ ___________
   3. Adjustments - Current Year ___________ ___________
   4. Total $ __________ $ __________

C. Amounts Recovered/Paid (cumulative)
   1. Prior Year(s) $ __________ $ __________
   2. Current Year ___________ ___________
   3. Total $ __________ $ __________

D. Special Surplus from Retroactive Insurance
   1. Initial $ __________ $ __________
   2. Adjustments - Prior Year(s) ___________ ___________
   3. Adjustments - Current Year ___________ ___________
   4. Closing Balance $ __________ $ __________

E. List the other insurers included in the above transactions

<table>
<thead>
<tr>
<th>Assumed Company</th>
<th>Assumed Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ __________</td>
</tr>
<tr>
<td></td>
<td>__________</td>
</tr>
<tr>
<td></td>
<td>__________</td>
</tr>
<tr>
<td></td>
<td>__________</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ __________ *</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ceded Company</th>
<th>Ceded Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ __________</td>
</tr>
<tr>
<td></td>
<td>__________</td>
</tr>
<tr>
<td></td>
<td>__________</td>
</tr>
<tr>
<td></td>
<td>__________</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ __________ *</td>
</tr>
</tbody>
</table>

* Total amounts must agree with totals in A.4.

25. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provide the following guidance for line 3 of Schedule F-Part 7, Provision for Overdue Reinsurance:

   Line 3 - Line 1 x Line 2
   If the company’s experience indicates that a higher amount should be provided, such higher amount should be entered

**Generally Accepted Accounting Principles**

26. As noted in paragraph 8, FAS 113 is generally consistent with Chapter 22. The paragraphs that follow are excerpts from FAS 113 which provide guidance on areas that differ from Chapter 22 (see paragraph 8 for a summary of differences).
27. FAS 113 eliminated the practice of insurance enterprises of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance:

Reporting Assets and Liabilities Related to Reinsurance Transactions

14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding enterprise's liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise's financial statements. Ceding enterprises shall report estimated reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.

15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of setoff exists, as defined in Interpretation 39.

16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

28. FAS 113 contains the following guidance on retroactive reinsurance agreements:

22. Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortized over the estimated remaining settlement period. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer (the interest method). Otherwise, the proportion of actual recoveries to total estimated recoveries (the recovery method) shall determine the amount of amortization.

23. If the amounts paid for retroactive reinsurance exceed the recorded liabilities relating to the underlying reinsured contracts, the ceding enterprise shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that the excess is charged to earnings.

24. Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts shall be recognized in earnings in the period of the change. Reinsurance receivables shall reflect the related change in the amount recoverable from the reinsurer, and a gain to be deferred and amortized, as described in paragraph 22, shall be adjusted or established as a result. When changes in the estimated amount recoverable from the reinsurer or in the timing of receipts related to that amount occur, a cumulative amortization adjustment shall be recognized in earnings in the period of the change so that the deferred gain reflects the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction.

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6 Decreases in the estimated amount of the liabilities shall reduce the related amount recoverable from the reinsurer and accordingly reduce previously deferred gains. However, if the revised estimate of the liabilities is less than the amounts paid to the reinsurer, a loss shall not be deferred. The resulting difference shall be recognized in earnings immediately as described in paragraph 23.
29. EITF 93-6 contains the following guidance on multiple-year retrospectively rated reinsurance contracts:

ISSUE

An insurer (ceding enterprise) may enter into a multiple-year retrospectively rated reinsurance contract (RRC) with a reinsurer (assuming enterprise). Examples of these contracts may include transactions referred to as “funded catastrophe covers.” These contracts include a “retrospective rating” provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding enterprise, or (2) changes in the contract’s future coverage. A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. A retrospectively rated contract that could be canceled by either party without further obligation is not covered by this Issue.

The issues are (1) to the extent that the ceding enterprise has an obligation to make payments to the reinsurer that would not have been required absent experience to date under the contract (for example, payments that would not have been required if losses had not been experienced), whether the ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset, (2) to the extent that a ceding enterprise would be entitled to receive a payment from the reinsurer based on experience to date under the contract (for example, the ceding enterprise would receive a payment if no future losses occur), whether the ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability, and (3) how to account for changes in coverage based on past experience under the contract.

EITF DISCUSSION

The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7(a) of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8 through 13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14(a) and (b) of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises. With respect to condition (2) above, a Task Force member asked whether a contract could be split for purposes of evaluating risk transfer. An FASB staff representative responded that Statement 113 applies to “a contract” and that determining the substance of a contract is a judgmental matter. If an agreement with a reinsurer consists of both risk transfer and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. The FASB staff representative noted that paragraphs 59 and 60 of Statement 113 indicate that the Board did not intend for different kinds of exposures combined in a program of reinsurance to be evaluated for risk transfer and accounted for together because that would allow contracts that do not meet the conditions for reinsurance accounting to be accounted for as reinsurance by being designated as part of a program that in total meets the conditions for reinsurance accounting.

For contracts that meet all of the conditions described above, the Task Force reached the following consensuses:

Issue 1. The ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset to the extent that the ceding enterprise has an obligation to pay cash (or other consideration) to the reinsurer that would not have been required absent experience under the contract. The amount recognized in the current period should be computed, using a with-and-
without method, as the difference between the ceding enterprise’s total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized.

In applying the consensus reached in Issue 1, if the ceding enterprise could terminate the contract prior to the end of its term and if termination would change the amounts paid (for example, if terminating the contract would cost less than continuing the contract in force), the liability resulting from the contract should be measured as follows:

1. If a decision to terminate has been made, the measurement should be based on an assumption of termination and experience to date.

2. Otherwise, the measurement should be based on the lesser of the following:
   a. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date) or
   b. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).

Issue 2. The ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming enterprise to the ceding enterprise based on experience to date under the contract.

Issue 3. The ceding enterprise and the assuming enterprise should account for changes in coverage in the same manner as changes in other contract costs. For example, the effects of decreases in coverage without a commensurate reduction in premium should be recognized as a loss by the ceding enterprise and as a gain by the assuming enterprise when the event causing the decrease in coverage takes place.

The Task Force noted that deposit accounting cannot be used to avoid loss recognition that would otherwise be required (for example, the ceding enterprise has no future coverage relating to the deposit with the reinsurer and therefore the deposit is not recoverable).

The provisions of these consensuses are effective as of July 22, 1993 (for example, they are to be initially applied no later than the third quarter of 1993 for calendar-year enterprises) and are to be initially applied in one of two ways:

1. By recognition of the net effect of applying the provisions at the beginning of an enterprise’s current fiscal year as a cumulative effect of a change in accounting principle in accordance with paragraph 20 of Opinion 20. Under this approach, the disclosures required by paragraph 21 of Opinion 20 would be required as long as the income statement for the current fiscal year is presented. The Task Force noted that the provisions of Statement 3 apply to all interim periods presented.

2. By restatement of financial statements for all periods presented as long as that restatement is not prohibited by Statement 113.
The SEC Observer stated that in addition to the disclosures provided under Opinion 20, the SEC staff will require registrants to disclose the nature and the significance of the transactions giving rise to the change. The SEC Observer also noted that registrants would be required to make SAB 74 disclosures for the financial statements filed prior to the period in which this change is adopted.

The Task Force requested that the FASB staff views on Issue 93-6, distributed to the Task Force as Supplement No. 1 (Revised) to the Issue Summary and the FASB Viewpoints article, “Accounting for Reinsurance: Questions and Answers about Statement 113,” be included in Appendix D of EITF Abstracts. [Note: See Appendix D, Topics No. 34 and 35.]

STATUS

A related issue was discussed in Issue No. 93-14, “Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises.” That Issue considers how a multiple-year retrospectively rated contract arising from an insurance transaction that is not a reinsurance contract should be accounted for. The consensuses reached in Issue 93-14 were consistent with those reached in this Issue.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force
- Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 65—Property and Casualty Contracts
- Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance, Chapters 7, 8, and 22 (including Appendix A)
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes to Financial Statements and Schedule F
- Minutes of the December 3, 1995, meeting of the Property Casualty Reinsurance Study Group

Generally Accepted Accounting Principles
- FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
- FASB Statement No. 5, Accounting for Contingencies
- FASB Emerging Issues Task Force Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises—SEC Staff Accounting Bulletin No. 92, Accounting and Disclosures Relating to Loss Contingencies
- AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 76

Offsetting and Netting of Assets and Liabilities

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not provide guidance on the reporting of assets and liabilities when a valid right of setoff exists (offsetting). As a result amounts are not consistently netted for statutory reporting. However, current statutory accounting does require that certain assets and liabilities be shown as a net amount for reporting purposes (netting) regardless of whether a valid right of setoff exists.

2. GAAP guidance on offsetting is provided in paragraph 7 of Accounting Principles Board Opinion No. 10, Omnibus Opinion - 1966 (APB 10) and FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts (FIN 39). This guidance allows offsetting only when a valid right of setoff exists and specified conditions are met or where netting is specifically permitted by other GAAP pronouncements. FIN 39 defines the conditions under which a valid right of setoff exists.

3. The purpose of this issue paper is to establish statutory accounting principles on offsetting assets and liabilities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) and to provide a reporting mechanism for the netting of assets and liabilities when required by this codification.

SUMMARY CONCLUSION

4. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 5 and 7. A right of setoff is a reporting entity’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the reporting entity. A valid right of setoff exists only when all the following conditions are met:

   a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement.
   
   b. The reporting party has the right to setoff the amount owed with the amount owed by the other party.
   
   c. The reporting party intends to setoff.
   
   d. The right of setoff is enforceable by law.

5. Assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific issue papers. An example of such is in the case of reinsurance recoverables on paid losses and ceded premiums payable as provided for in Issue Paper No. 75—Property and Casualty Reinsurance (Issue Paper No. 75).
6. Amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 4 above are met.

7. Netting of assets and liabilities for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific issue papers. An example of such is in the case of real estate investments required to be shown net of encumbrances as provided for in Issue Paper No. 40—Real Estate Investments (Issue Paper No. 40).

**DISCUSSION**

8. The conclusions above require offsetting when a valid right of setoff exists, unless prohibited in specific issue papers. This issue paper adopts paragraphs 1, 7, and 13 of APB 10 and FIN 39 with a modification to prohibit offsetting as provided in specific issue papers and require netting when provided in specific issue papers. GAAP uses the same criteria to permit offsetting as described in paragraph 4 of this issue paper and also permits netting where existing GAAP literature specifically prescribes it. Because this modification exists, there will be circumstances where items are offset under GAAP but not under statutory accounting principles.

9. Likewise, there are instances as provided for in specific issue papers where balances which do not meet the criteria in paragraph 4 are shown net for statutory reporting purposes where existing GAAP literature would not allow the amounts to be reflected as a single net balance. This difference is reflective of the varying objectives of regulation.

10. **FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements** (FIN 41) is a further interpretation of paragraph 7 of APB 10 and FIN 39. The guidance adopted in Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (Issue Paper No. 45) is consistent with FIN 41. However, Issue Paper No. 45 did not adopt FIN 41 because offsetting was not addressed in its entirety in the paper. The adoption of paragraph 7 of APB 10 and FIN 39 make it appropriate to adopt FIN 41 in this issue paper. This issue paper also adopts FASB Emerging Issues Task Force No. 86-25, **Offsetting Foreign Currency Swaps**.

11. The statutory principles outlined in the conclusion above are consistent with the consistency concept in the Statement of Concepts. A pertinent excerpt follows:

   **Consistency**

   The regulators’ need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles.

12. The conclusions reached in this issue paper are consistent with the definition of liabilities in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) which defines a liability as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s) and the definition of assets in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets (Issue Paper No. 4) which defines an asset as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Assets and liabilities exist independent of each other unless the requirements of paragraph 4 of this issue paper are met.

**Drafting Notes/Comments**

- **Issue Paper No. 2—Definition of Cash** requires netting cash accounts with positive and negative balances.
- **Issue Paper No. 40—Real Estate Investments** requires encumbrances on real estate investments to be netted against the investment.

- **Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance** prohibits offsetting of reinsurance recoverables on paid losses with ceded premiums payable and requires due premiums from policyholders to be netted with premiums due the reinsurer.

- **Issue Paper No. 75—Property and Casualty Reinsurance** prohibits offsetting of reinsurance recoverables on paid losses with ceded premiums payable.

- **Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements** addresses FIN 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*.

**RELEVANT STATUTORY AND GAAP GUIDANCE**

**Statutory Accounting**

13. The Property and Casualty Accounting Practices and Procedures Manual (P&C Accounting Practices and Procedures Manual), Chapter 22, Reinsurance, provides the following guidance:

**Accounting for Prospective Reinsurance Contracts:**

Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

Changes in amounts of estimated recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current period’s statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, “reinsurance recoverables on loss and loss adjustment expense payments”, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

**Accounting for Retroactive Reinsurance Contracts:**

Certain reinsurance contracts which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the contract. Due to potential abuses involving the creation of surplus to policyholders, and the distortion of underwriting results, a special accounting treatment for such agreements is warranted.

Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for in the following manner:

1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.

2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.

3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as “retroactive reserve ceded or assumed” recorded as a contra-liability by the ceding company and as a liability by the assuming company.
14. The P&C Accounting Practices and Procedures Manual, Chapter 4, Real Estate, provides the following guidance:

**Book Value**

In general, book value refers to amounts at which individual items are stated in books of account of in financial statements. For real estate that is occupied by the company, and for investment in real estate, this would be cost or other basic value, stated net of any encumbrances, plus additions and increases by adjustments, less retirements and decreases by adjustments, including depreciation. Encumbrances include mortgages and other related debt, and may also include accrued costs of acquisition or construction.

**Statement Value**

Real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual costs, plus capitalized improvement, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

Similar guidance is provided in The Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4, Real Estate.

**Generally Accepted Accounting Principles**

15. Paragraph 7 of APB 10 provides the following guidance:

1. It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists. Accordingly, the offset of cash or other assets against the tax liability or other amounts owing to governmental bodies is not acceptable except in the circumstances described in paragraph 3 below.

2. Most securities now issued by governments are not by their terms designed specifically for the payment of taxes and, accordingly, should not be deducted from taxes payable on the balance sheet.

3. The only exception to this general principle occurs when it is clear that a purchase of securities (acceptable for the payment of taxes) is in substance an advance payment of taxes that will be payable in the relatively near future, so that in the special circumstances the purchase is tantamount to the prepayment of taxes. This occurs at times, for example, as an accommodation to a local government and in some instances when governments issue securities that are specifically designated as being acceptable for the payment of taxes of those governments.

16. FIN 39 provides the following guidance:

**INTERPRETATION**

**General Principle**

5. Opinion 10, paragraph 7, states that “it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.” A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:

a. Each of two parties owes the other determinable amounts.
b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
c. The reporting party intends to set off.
d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.

6. Generally, debts may be set off if they exist between mutual debtors each acting in its capacity as both debtor and creditor. In particular cases, however, state laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.

Special Applications

7. Various accounting pronouncements specify accounting treatments in circumstances that result in offsetting or in a presentation in a statement of financial position that is similar to the effect of offsetting. This Interpretation does not modify the accounting treatment in the particular circumstances prescribed by any of the following pronouncements:

FASB Statements and Interpretations
APB Opinions
Accounting Research Bulletins
FASB Technical Bulletins
AICPA Accounting Interpretations
AICPA Audit and Accounting Guides
AICPA Industry Audit Guides
AICPA Statements of Position

Examples of those pronouncements are:
FASB Statement No. 13, Accounting for Leases (leveraged leases, paragraphs 42-47)
FASB Statement No. 87, Employers’ Accounting for Pensions (accounting for pension plan assets and liabilities)
FASB Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions (accounting for plan assets and liabilities)
FASB Statement No. 109, Accounting for Income Taxes (net tax asset or liability amounts reported)
APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions (reporting of discontinued operations)
AICPA Audit and Accounting Guides, Audits of Brokers and Dealers in Securities (trade date accounting for trading portfolio positions), and Construction Contractors and Audits of Federal Government Contractors (advances received on construction contracts)
AICPA Industry Audit Guide, Audits of Banks (reciprocal balances with other banks)

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 4 and 22
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4
- Issue Paper No. 2—Definition of Cash
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 40—Real Estate Investments

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- Issue Paper No. 75—Property and Casualty Reinsurance
- Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance
- Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements.

Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 10, Omnibus Opinion - 1966
- FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts
- FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements
- FASB Emerging Issues Task Force No. 86-25, Offsetting Foreign Currency Swaps

State Regulations

No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 77

Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. GAAP guidance for the disclosure of accounting policies is contained in Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies (APB 22). This guidance requires the identification and description of accounting principles followed by a company and the methods of applying those principles that materially affect the determination of financial position or results of operations. Current statutory guidance requires a general disclosure that the financial statements have been prepared in accordance with the Annual Statement Instructions and Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) except to the extent state laws differ. The impact of such deviations is required to be disclosed if material. The disclosure of certain accounting policies within specific notes to the Annual Statement is required by the Annual Statement Instructions.

2. GAAP guidance for the disclosure of permitted accounting practices is contained in AICPA Statement of Position No. 94-5, Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises (SOP 94-5). This guidance requires the disclosure of those permitted statutory accounting practices that have a material impact on statutory surplus or risk based capital or when prescribed statutory accounting practices do not address the accounting for the transaction. Current statutory guidance is contained in the Annual Statement Instructions for both Property and Casualty and Life, Accident and Health Insurance Companies (Annual Statement Instructions), Notes to the Financial Statements. This guidance requires the disclosure of any accounting practices not in conformity with the Annual Statement Instructions and the Accounting Practices and Procedures Manuals.

3. GAAP guidance for the disclosure of risk and uncertainties is contained in AICPA Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties (SOP 94-6). This guidance requires the disclosure about risks and uncertainties in four areas at the date of the financial statements: nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations. Current statutory guidance requires certain specific disclosures of risks and uncertainties, however, the requirements are not as broad as those of SOP 94-6.

4. The purpose of this issue paper is to establish statutory accounting principles for the disclosure of accounting policies, risks and uncertainties, and other disclosures that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

5. Except as noted in paragraph 8, the disclosure requirements of paragraphs 6 through 21 of this issue paper do not apply to quarterly financial statements. To the extent that disclosures required by this or any other issue paper are made within specific notes, schedules or exhibits to the financial statements, those disclosures are not required to be duplicated in a separate note. Annual statutory financial
statements which are not accompanied by Annual Statement exhibits and schedules (e.g., annual audit report) shall include all disclosures required by this statement.

**Accounting Policies**

6. For the purposes of this issue paper, accounting polices are defined as the specific accounting principles and the methods of applying those principles that are utilized in preparing the statutory financial statements.

7. Disclosure shall be made of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations of the reporting company. The disclosure should encompass important judgments as to the appropriateness of principles relating to recognition of revenue particularly when selecting between acceptable alternatives, or methods particular to the business.

8. Disclosure of accounting policies generally should be made in a separate *Summary of Significant Accounting Policies* preceding the notes to the financial statements or as the initial note. If the reporting entity has changed the accounting policies since the end of its preceding year, the changes shall be disclosed in the quarterly financial statements.

9. NAIC statutory accounting practices and procedures are those that are set forth in the Accounting Practices and Procedures Manual. If a reporting entity employs accounting practices that depart from NAIC accounting practices and procedures, disclosure of the following information about those accounting practices that affect statutory surplus or risk-based capital shall be made:
   b. A statement that the accounting practice differs from NAIC statutory accounting practices and procedures.
   c. The monetary effect on statutory surplus of using an accounting practice which differs from NAIC statutory accounting practices and procedures.

10. Disclosure of the following information shall be made about accounting practices when NAIC statutory accounting practices and procedures do not address the accounting for the transaction:
    a. A description of the transaction and of the accounting practice used.
    b. A statement that NAIC statutory accounting practices and procedures do not address the accounting for the transaction.

**Risks and Uncertainties**

11. Companies shall make disclosures in their financial statements about risks and uncertainties existing as of the date of those statements in the following areas:
    a. Nature of operations
    b. Use of estimates in the preparation of financial statements
    c. Certain significant estimates
    d. Current vulnerability due to certain concentrations

12. *Nature of Operations*: Financial statements should include a description of the ownership and relationships of the reporting entity and all affiliated companies, and a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative
importance of its operations in each business and the basis for the determination (e.g., assets, revenues, or earnings). Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as predominately, about equally, or major.

13. **Use of Estimates in the Preparation of Financial Statements:** Financial statements shall include an explanation that the preparation of financial statements in conformity with the Annual Statement Instructions and Accounting Practices and Procedures Manuals requires the use of management’s estimates.

14. **Certain Significant Estimates:** Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

   a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

   b. The effect of the change would be material to the financial statements.

The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term (generally, a period of time not to exceed one year from the date of the financial statements). If the estimate involves a loss contingency as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies, and Impairments of Assets* (Issue Paper No. 5), the disclosure shall include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Reporting entities should disclose the factors that cause the estimate to be sensitive to change.

15. **Current Vulnerability Due to Certain Concentrations:** Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks manifest themselves differently, depending on the nature of the concentration, and vary in significance.

16. Financial statements shall disclose the concentrations described in paragraph 17 of this issue paper if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

   a. The concentration exists at the date of the financial statements.

   b. The concentration makes the enterprise vulnerable to the risk of a near-term severe (more than material but less than catastrophic) impact.

   c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

17. Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph 16 of this issue paper. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

   a. **Concentrations in the volume of business transacted with a particular customer, supplier, or lender.** The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For the purposes of this issue paper, it is always considered at least reasonably possible that any customer will be lost in the near term.
b. Concentrations in revenue from particular products or services. The potential for severe impact can result, for example, from volume or price changes for a particular source of revenue.

c. Concentrations in the available sources of materials, labor, services, licenses, or other rights used in the entity’s operations. The potential for severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. Concentrations in the market or geographic area in which an entity conducts its operations. The potential for severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For the purposes of this issue paper, it is always considered at least reasonably possible that operations located outside an entity’s home country will be disrupted in the near term.

Other Disclosures
18. Separate issue papers have disclosure requirements specific to the topics addressed in those issue papers. Additional disclosure requirements not addressed in other issue papers are included herein.

19. For each year that a balance sheet is presented, reporting entities shall disclose the following information in the notes to the financial statements:

   a. Amounts not recorded in the financial statements that represent segregated funds held for others, the nature of the assets and the related fiduciary responsibilities associated with such assets. One example of such an item is escrow accounts held by title insurance companies.

   b. The amount and nature of any assets pledged to others as collateral.

20. The financial statements shall disclose forward commitments which are not derivative instruments (e.g., the commitment to purchase a GNMA security two months after the commitment date, or a private placement six months after the commitment date).

Supplemental Investment Disclosure
21. For the current year, reporting entities shall disclose the information required by Appendix A-001, Investments of Insurers. A Summary Investment Schedule and Investment Risk Interrogatories shall be filed with the audited statutory financial statements. The Summary Investment Schedule shall be filed with the Annual Statement whereas the interrogatories shall be filed as a supplement to the Annual Statement by April 1 for the applicable reporting period.

DISCUSSION
22. This issue paper adopts APB 22, Accounting Research Bulletin No. 43, Chapter 2A, Form of Statements — Comparative Financial Statements, SOP 94-5 and SOP 94-6. The disclosures related to loss reserves adopted in Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses (Issue Paper No. 55), are consistent with the guidance in SOP 94-5. However, Issue Paper No. 55 did not adopt SOP 94-5 because it was to be addressed in its entirety in this issue paper.
23. The statutory principles outlined in the conclusion above expand current statutory guidance relative to accounting policies, risks and uncertainties and other disclosures as follows:

   a. Paragraph 7 of this issue paper requires disclosure of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations in all statutory financial statements. Current statutory guidance requires disclosure of certain accounting policies in the notes to the Annual Statement as well as disclosure of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations but only to the extent those financial statements are audited.

   b. Paragraph 11 requires the disclosure of certain risks and uncertainties existing at the date of the financial statements. Current statutory guidance requires this disclosure in statutory financial statements to the extent those financial statements are audited. This issue paper expands that requirement to include annual statement filings.

These changes were made to enhance the usefulness of financial statements to regulators and other users.

24. The statutory principles outlined in paragraphs 9 and 10 in the conclusion above expand current statutory guidance by requiring disclosure of accounting practices that depart from NAIC accounting practices and procedures and that have an effect on risk based capital or statutory surplus. This change was made because risk based capital is viewed as a primary indicator of a reporting entity’s solvency.

25. The disclosure requirements of this issue paper are consistent with the Statement of Concepts which states “... management must supplement the financial statements with sufficient disclosures (e.g., notes to financial statements, management discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.”

26. The conclusions reached in this issue paper are consistent with GAAP except to the extent they are not required to be made in interim statutory financial statements. GAAP requires these disclosures in all financial statements regardless of the period.

27. The information required by this issue paper provides disclosure in those circumstances where the accompanying exhibits and schedules are not part of the company’s financial statements (e.g., annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

Drafting Notes/Comments
- The disclosure requirements of this issue paper relative to risks and uncertainties are separate from and do not change in any way the requirements or criteria of Issue Paper No. 5.
- Disclosures relating to environmental liabilities are addressed in Issue Paper No. 65—Property Casualty Contracts.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting
28. The Annual Statement Instructions for both Property and Casualty and Life, Accident and Health Insurance Companies (Notes to the Financial Statements) provide the following guidance:

   1. Basis of Presentation

      Instruction:

      Indicate that the statement has been completed in accordance with the NAIC Annual Statement Instructions and Accounting Practices and Procedures manuals except to the extent that state law differs. Note any deviations from the rules to the extent this deviation impacts the financial information contained in the annual statement.
Illustration:

The accompanying financial statements of the Company have been prepared in conformity with the Annual Statement Instructions and Accounting Practices and Procedures Annual Statement Instructions except for the following item(s) which resulted in surplus being increased (decreased) by $__________. The deviation(s) are as follows:

Generally Accepted Accounting Principles

29. APB 22 provides the following guidance (note all references to statement of changes in financial position have been amended to statement of cash flows by FASB Statement No. 95, Statement of Cash Flows):

DISCUSSION

5. Financial statements are the end product of the financial accounting process, which is governed by generally accepted accounting principles on three levels: pervasive principles, broad operating principles, and detailed principles. Applying generally accepted accounting principles requires that judgment be exercised as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic activities. Although the combined efforts of professional accounting bodies, of business, and of the regulatory agencies have significantly reduced the number of acceptable alternatives and are expected to reduce the number further, judgment must nevertheless be exercised in applying principles at all three levels.

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1 See APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, Chapter 6, 7, and 8. This Opinion amends Statement No. 4 insofar as it relates to disclosure of accounting policies.

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6. The accounting policies of a reporting entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles and that, accordingly, have been adopted for preparing the financial statements.

7. The accounting policies adopted by a reporting entity can affect significantly the presentation of its financial position, cash flows, and results of operations. Accordingly, the usefulness of financial statements for purposes of making economic decisions about the reporting entity depends significantly upon the user’s understanding of the accounting policies followed by the entity.

OPINION

Applicability

8. The Board concludes that information about the accounting policies adopted by a reporting entity is essential for financial statement users. When financial statements are issued purporting to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles, a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements. In circumstances where it may be appropriate to issue one or more of the basic financial statements without the others, purporting to present fairly the information given in accordance with generally accepted accounting principles, statements so presented should also include disclosure of the pertinent accounting policies.
Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

9. The Board also concludes that information about the accounting policies adopted and followed by not-for-profit entities should be presented as an integral part of their financial statements.

10. The provisions of paragraphs 8 and 9 above are not intended to apply to unaudited financial statements issued as of a date between annual reporting dates (e.g., each quarter) if the reporting entity has not changed its accounting policies since the end of its preceding fiscal year.

2 The Board recognizes also that it may be appropriate to omit disclosure in some other circumstances for example, from financial statements restricted to internal use only (see Statement on Auditing Procedures No. 38, paragraphs 5 and 6) and from certain special reports in which incomplete or no financial presentations are made (see Statement on Auditing Procedures No. 33, Chapter 13, paragraphs 9 and 10).

11. This Opinion does not supersede any prior pronouncement of the American Institute of Certified Public Accountants relating to disclosure requirements.

Content

12. Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives;

b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;

c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

13. Examples of disclosures by a business entity commonly required with respect to accounting policies would include, among others, those relating to basis of consolidation, depreciation methods, amortization of intangibles, inventory pricing, accounting for research and development costs (including basis for amortization), translation of foreign currencies, recognition of profit on long-term construction-type contracts, and recognition of revenue from franchising and leasing operations. This list of examples is not all-inclusive.

14. Financial statement disclosure of accounting policies should not duplicate details (e.g., composition of inventories or of plant assets) presented elsewhere as part of the financial statements. In some cases, the disclosure of accounting policies should refer to related details presented elsewhere as part of the financial statements; for example, changes in accounting policies during the period should be described with cross-reference to the disclosure required by APB Opinion No. 20, Accounting Changes, of the current effect of the change and of the pro forma effect of retroactive application.

Format

15. The Board recognizes the need for flexibility in matters of format (including the location) of disclosure of accounting policies provided that the reporting entity identifies and describes its significant accounting policies as an integral part of its financial statements in accordance with
the foregoing guides in this Opinion. The Board believes that the disclosure is particularly useful if given in a separate Summary of Significant Accounting Policies preceding the notes to financial statements or as the initial note. Accordingly, it expresses its preference for that format under the same or a similar title.

30. SOP 94-6 provides the following guidance:

**Introduction**

.01 The volatile business and economic environment underscores a need for improved disclosure about the significant risks and uncertainties that face reporting entities. In 1987, the AICPA issued the Report of the Task Force on Risks and Uncertainties (the Report), which was intended to help standards setting bodies and others identify practical methods of improving the information communicated to users of financial statements to help them assess those risks and uncertainties. This Statement of Position (SOP) is largely based on the Report. The central feature of this SOP’s disclosure requirements is selectivity: specified criteria serve to screen the host of risks and uncertainties that affect every entity so that required disclosures are limited to matters significant to a particular entity.

.02 The disclosures focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties this SOP deals with can stem from the nature of the entity’s operations, from the necessary use of estimates in the preparation of the entity’s financial statements, and from significant concentrations in certain aspects of the entity’s operations.

**Scope**

.03 This SOP applies to financial statements prepared in conformity with generally accepted accounting principles (GAAP) applicable to nongovernmental entities. It applies to all entities that issue such statements. While this SOP applies to complete interim financial statements, it does not apply to condensed or summarized interim financial statements. If comparative financial statements are presented, the disclosure requirements apply only to the financial statements for the most recent fiscal period presented.

1 However, see Accounting Principles Board (APB) Opinion No. 28, Interim Financial Reporting, paragraph 30, for guidance on disclosure of contingencies in summarized interim financial information of publicly traded companies.

.04 The disclosure requirements do not encompass risks and uncertainties that might be associated with management or key personnel, proposed changes in government regulations; proposed changes in accounting principles, or deficiencies in the internal control structure. Nor do they encompass the possible effects of acts of God, war, or sudden catastrophes.

**Relationship to Other Pronouncements**

.05 The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain pronouncements of the Financial Accounting Standards Board (FASB), such as FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, and, for public business enterprises, FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise. The disclosure requirements of this SOP in many circumstances also are similar to or overlap the disclosure requirements in certain pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter the requirements of any FASB or SEC pronouncement.

.06 Certain disclosure requirements in this SOP supplement the requirements of other authoritative pronouncements. In many cases, however, the disclosure requirements in this SOP, particularly those relating to certain significant estimates, will be met or partly met by compliance with such other pronouncements.
Definitions
.07 This SOP uses the following terms with the definitions indicated:

Near term. A period of time not to exceed one year from the date of the financial statements.

Severe impact. (Used in reference to current vulnerability due to certain concentrations. See paragraph .21.) A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the enterprise itself. The concept of severe impact, however, includes matters that are less than catastrophic.

Conclusions
.08 The Accounting Standards Executive Committee (AcSEC) of the AICPA has concluded that reporting entities should make disclosures in their financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations
b. Use of estimates in the preparation of financial statements
c. Certain significant estimates
d. Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly; the disclosures required by this SOP may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

.09 The following detailed discussion of the four areas of disclosure enumerated in paragraph .08 should be read in conjunction with the "Illustrative Disclosures" in appendix A [paragraph .27] of this SOP, which provide guidance for implementing them.

Nature of Operations
.10 Financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination for
example assets, revenues, or earnings. Not-for-profit organizations’ disclosures should briefly describe the principal services performed by the entity and the revenue sources for the entity’s services. Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as predominately, about equally, or major and other.5

Use of Estimates in the Preparation of Financial Statements

.11 Financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management’s estimates.

Certain Significant Estimates

.12 Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, paragraphs 9 through 12, and 17b, and footnote 6 of FASB Statement No. 5 specify disclosures to be made about contingencies 6 that exist at the date of the financial statements. The disclosure requirements of paragraphs 9 through 12 of Statement No. 5 are further clarified in FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss. In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below

5 See paragraph B-17 in appendix B [paragraph .28] for a comparison of this SOP’s disclosure requirements concerning nature of operations with the disclosure requirements for public companies in FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise.

6 FASB Statement No. 5 defines a contingency as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a ‘gain contingency’) or loss (hereinafter a ‘loss contingency’) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.”

.13 Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

a. It is at least reasonably possible7 that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

7 The term reasonably possible is used in this SOP consistent with its use in FASB Statement No. 5 to mean that the chance of a future transaction or event occurring is more than remote but less than likely.

b. The effect of the change would be material to the financial statements.
.14 The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible\(^8\) that a change in the estimate will occur in the near term.\(^9\) If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

\(^{8}\) The words reasonably possible need not be used in the disclosures required by this SOP

\(^{9}\) FASB Statement No. 5 states in paragraph 17b that “adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization”

.15 Many entities use risk-reduction techniques to mitigate losses or the uncertainty that may result from future events. If the entity determines that the criteria in paragraph .13 are not met as a result of risk-reduction techniques, the disclosures described in paragraph .14 and disclosure of the risk reduction techniques are encouraged but not required.

.16 This SOP’s disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5; rather, the disclosures required under this SOP supplement the disclosures required under Statement No. 5 as follows:

- If an estimate (including estimates that involve contingencies covered by FASB Statement No. 5) meets the criteria for disclosure under paragraph .13 of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; FASB Statement No. 5 does not distinguish between near-term and long-term contingencies.
- An estimate that does not involve a contingency covered by Statement No. 5, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph .13. This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

.17 Whether an estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.

.18 The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Capitalized motion picture film production costs
- Capitalized computer software costs
- Deferred policy acquisition costs of insurance enterprises
- Valuation allowances for commercial and real estate loans
- Environmental remediation-related obligations
- Litigation-related obligations
- Contingent liabilities for obligations of other entities
• Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
• Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
• Amounts reported for long-term contracts

The above list is not intended to be all-inclusive.

.19 The following are examples of events or changes in circumstances that indicate that an estimate associated with the carrying amount of a long-lived asset may be particularly sensitive to change in the near term: 10

   a. A significant decrease in the market value of an asset
   b. A significant change in the extent or manner in which an asset is used
   c. A significant adverse change in legal factors or in the business climate that affects the value of an asset
   d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset
   e. A history of losses associated with an asset, a projection or forecast (if either is available) that demonstrates continuing losses associated with an asset, or both

10 On November 29, 1993, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, Accounting for the Impairment of Long-Lived Assets. This list was derived from the list in the FASB exposure draft of examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of a long-lived asset should be assessed for impairment. Any final Statement may contain additional or revised examples.

Current Vulnerability Due to Certain Concentrations

.20 Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

.21 Financial statements should disclose the concentrations described in paragraph .22 if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

   a. The concentration exists at the date of the financial statements.
   b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
   c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

.22 Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph .21. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

   a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For
purposes of this SOP, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.

b. Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity’s operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. Concentrations in the market or geographic area 11 in which an entity conducts its operations. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity’s home country will be disrupted in the near term.

11 FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise, paragraph 34, provides guidance on determining foreign geographic areas

.24 Disclosure of concentrations meeting the criteria of paragraph .21 should include information that is adequate to inform users of the general nature of the risk associated with the concentration. For those concentrations of labor (paragraph .22c) subject to collective bargaining agreements and concentrations of operations located outside of the entity’s home country (paragraph .22d) that meet the criteria of paragraph .21, the following specific disclosures are required:

- For labor subject to collective bargaining agreements, disclosure should include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.
- For operations located outside the entity’s home country, disclosure should include the carrying amounts of net assets and the geographic areas in which they are located.

Adequate information about some concentrations may already be presented in diverse parts of the financial statements. For example, adequate information about assets or operations located outside the entity’s home country may be included in disclosures made to comply with FASB Statement No. 14. In accordance with paragraph .08 of this SOP, such information need not be repeated.

Application of Disclosure Criteria
.25 An assessment of whether a disclosure is required should not be found to be in error simply as a result of future events; For example, reporting a concentration not followed by a severe impact does not imply that the disclosure should not have been made, because something that has only a reasonably possible chance of occurring obviously might not occur. Similarly, the occurrence of a severe impact related to a concentration not disclosed in the prior-year financial statements would not suggest noncompliance with this SOP’s requirements if an appropriate judgment had been made that a near term severe impact was not at least reasonably possible at the prior reporting date. In addition, a severe impact may arise from a concentration of which management did not have knowledge at the time the financial statements were issued.
31. **SOP 94-5 provides the following guidance:**

**Introduction**

.01 Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises’ financial statements. This statement of position (SOP) is a result of that project.

.02 This SOP applies to annual and complete sets of interim financial statements prepared in conformity with generally accepted accounting principles (GAAP) of life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. Furthermore, AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, Professional Standards, vol. 1, AU section 9623.60.79), requires auditors to apply the same disclosure criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.

**Relationship to Other Pronouncements**

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

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


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

**Conclusions**

.04 The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures" [paragraph .13], and appendix B, "Discussion of Conclusions" [paragraph .14], of this SOP.

**Permitted Statutory Accounting Practices**

.05 Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The National Association of Insurance Commissioners (NAIC) currently
has a project under way to codify statutory accounting practices through a complete revision of its
Accounting Practices and Procedures Manuals, that, when complete, is expected to replace
prescribed or permitted statutory accounting practices as the statutory basis of accounting for
insurance enterprises (referred to hereafter as the "codification"). Therefore, the codification will
likely result in changes to what is currently considered a prescribed statutory accounting practice.
Furthermore, postcodification permitted statutory accounting practices will be exceptions to the
statutory basis of accounting.

.06 Prescribed precodification statutory accounting practices include state laws, regulations, and
general administrative rules applicable to all insurance enterprises domiciled in a particular state,
NAIC Annual Statement Instructions; the NAIC Accounting Practices and Procedures Manuals;
the Securities Valuation Manual (published by the NAIC Securities Valuation Office); NAIC official
proceedings; and the NAIC Examiners’ Handbook.

.07 Permitted statutory accounting practices include practices not described in paragraph .06 but
allowed by the domiciliary state insurance department. Insurance enterprises may request
permission from the domiciliary state insurance department to use a specific accounting practice
in the preparation of their statutory financial statements (a) when the enterprise wishes to depart
from the prescribed statutory accounting practices, or (b) when prescribed statutory accounting
practices do not address the accounting for the transaction.

.08 The disclosures in this paragraph should be made for permitted statutory accounting
practices for the most recent fiscal year presented regardless of when the permitted statutory
accounting practice was initiated. Insurance enterprises should disclose the following information
about permitted statutory accounting practices that individually or in the aggregate materially
affect statutory surplus or risk-based capital, including GAAP practices when the permitted
practices differ from the prescribed statutory accounting practices:

a. A description of the permitted statutory accounting practice
b. A statement that the permitted statutory accounting practice differs from prescribed
statutory accounting practices
c. The monetary effect on statutory surplus

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

a. A description of the transaction and of the permitted statutory accounting practice used
b. A statement that prescribed statutory accounting practices do not address the accounting
for the transaction

APPENDIX A

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

Permitted Statutory Accounting Practices
A-2. The following is an illustration of disclosures that an insurance enterprise would make before
the codification is complete, to meet the requirements of paragraph .08 of this SOP.
Note X. Permitted Statutory Accounting Practices

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

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

RELEVANT LITERATURE

Statutory Accounting
- NAIC Annual Statement Instructions
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses

Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies
- Accounting Research Bulletin No. 43, Chapter 2A, Form of Statements – Comparative Financial Statements
- AICPA Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties
- AICPA Statement of Position No. 94-5, Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 78

Employee Stock Ownership Plans

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for the plan sponsors’ accounting for Employee Stock Ownership Plans (ESOPs) is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health (Life/A&H Accounting Practices and Procedures Manual) and for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance provides that debt obligations of ESOPs must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities.

2. GAAP addresses the plan sponsors’ accounting for ESOPs in AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans (SOP 93-6) and FASB Emerging Issues Task Force Issue No. 89-11, Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan (EITF 89-11).

3. The purpose of this issue paper is to establish statutory accounting principles for the plan sponsors’ accounting for ESOPs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It does not address financial reporting by ESOPs.

SUMMARY CONCLUSION

4. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 as a stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. For such plans, reporting entities shall adopt SOP 93-6 except that debt obligations of ESOPs shall be reported consistent with Issue Paper No. 80—Debt (Issue Paper No. 80) and the related income tax effects shall be accounted for consistent with Issue Paper No. 83—Accounting for Income Taxes (Issue Paper No. 83), as further clarified in this issue paper. There are two basic forms of ESOPs: nonleveraged and leveraged. A summary of the financial reporting for each is provided below.

Leveraged ESOPs

5. A leveraged ESOP borrows money to acquire shares of the employer company (sponsor). The money may be borrowed from the plan sponsor or from an outside lender, with or without a guarantee from the plan sponsor. The debt usually is collateralized by the employer’s shares. As required by Issue Paper No. 80, debt obligations of ESOPs shall be reported as borrowed money by company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company, or the sale or exchange of the company’s securities.
6. The sponsor shall report the issuance of shares or the sale of treasury shares to an ESOP when they occur. The consideration recorded for the stock issued is unearned compensation and the unearned ESOP shares shall be reported as a separate reduction of surplus as a component of unassigned funds.

7. The unearned shares initially held by the ESOP in a suspense account are called suspense or unallocated shares. As the debt is repaid (generally from employer contributions and dividends on the employer’s stock) suspense shares are released and must be allocated to individual accounts as of the end of the ESOP’s fiscal year. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged as outlined in paragraph 26 of this issue paper.

8. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes (although such dividends are generally subject to normal dividend requirements under state statutes or regulations). Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost. Dividends on allocated shares should be charged to unallocated surplus.

9. If the ESOP sells the suspense shares and uses the proceeds to repay the debt, the employer shall report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, such difference shall be reported as a capital gain or loss on extinguishment of debt as defined in Issue Paper No. 80 and, accordingly, shall be charged to operations and disclosed in the notes to the financial statements in accordance with Issue Paper No. 24—Discontinued Operations and Extraordinary Items (Issue Paper No. 24).

10. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction as outlined in paragraph 26 of this issue paper.

Nonleveraged ESOPs

11. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan as outlined in paragraph 26 of this issue paper.

12. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to unallocated surplus, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Pension Reversion ESOPs

13. Pension reversion ESOPs are created by transferring the assets of a defined benefit pension plan to an existing or newly created ESOP and may be leveraged or nonleveraged. Pension reversion ESOPs should be accounted for as outlined in paragraph 26 of this issue paper.

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

14. The amount of ESOP-related expense for a leveraged ESOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Such differences should be reported in accordance with Issue Paper No. 83.

15. If the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to unassigned funds. Conversely, if the cost of shares committed to be released is less than their fair value,
the employer should charge the tax effect of the amount by which the book expense exceeds the
deductible expense to unassigned funds to the extent of previous credits to unassigned funds related to
cost exceeding fair value of ESOP shares committed to be released in previous periods.

16. Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be
recorded as a reduction of income tax expense allocated to continuing operations.

Nonleveraged ESOPs
17. Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting
purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost
earlier for financial reporting purposes creates a temporary difference that shall be accounted for in
accordance with Issue Paper No. 83.

Other
18. Under federal income tax regulations, employer securities (such as convertible preferred stock)
that are held by participants in an ESOP and that are not readily tradable on an established market must
include a put option. Securities subject to such repurchase obligations shall be reported as outstanding and
as a component of surplus. The repurchase obligation shall be disclosed in accordance with paragraph 19
below.

Disclosures
19. An employer sponsoring an ESOP shall disclose the following information about the plan, if
applicable.

   a. A description of the plan, the basis for determining contributions, including the employee
groups covered, and the nature and effect of significant matters affecting comparability of
information for all periods presented. For leveraged ESOPs and pension reversion
ESOPs, the description should include the basis for releasing shares and how dividends
on allocated and unallocated shares are used;

   b. A description of the accounting policies followed for ESOP transactions, including the
method of measuring compensation and the classification of dividends on ESOP shares;

   c. The amount of compensation cost recognized during the period;

   d. The number of allocated shares, committed-to-be-released shares, and suspense shares
held by the ESOP at the balance sheet date;

   e. The fair value of unearned ESOP shares at the balance sheet date;

   f. The existence and nature of any repurchase obligation, including disclosure of the fair
value of the shares allocated as of the balance sheet date, which are subject to a
repurchase obligation.

DISCUSSION
and Procedures Manual provide that debt obligations of Employee Stock Ownership Plans (ESOPs) must
be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and
intent to satisfy the debt from sources other than dividends on the company stock, contributions from the
company or the sale or exchange of the company’s securities. This issue paper is consistent with current
statutory guidance. It expands on current statutory guidance to address the accounting for ESOPs in
greater detail and to expand the disclosure requirements for ESOPs.
21. This issue paper adopts the GAAP guidance set forth in SOP 93-6 except for:

a. Paragraphs 13 and 25 to the extent that those paragraphs require reporting all debt obligations of an ESOP as liabilities. Statutory accounting provides an exception in situations where the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities. Pursuant to current statutory guidance and Issue Paper No. 80, such obligations do not meet the definition of liabilities (of the sponsor) as defined in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.

b. Paragraphs 28 through 34 and paragraphs 44 and 53 b. as they relate to the calculation and reporting of earnings per share.

c. Paragraph 37 as it relates to reporting gains and losses on extinguishment of debt. Such gains and losses shall be accounted for and disclosed consistent with Issue Paper No. 24.

22. Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an ESOP and that are not readily tradable on an established market must include a put option. Pursuant to Securities and Exchange Commission (SEC) Codification of Financial Reporting Policies, Section 211 - Redeemable Preferred Stocks, SEC reporting companies are required to report such securities outside of permanent equity for GAAP reporting purposes. The SEC states that there is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The SEC believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital. There is no such requirement for non-SEC reporting companies. Paragraph 18 of this issue paper requires reporting of such securities consistent with the GAAP requirements for non-SEC reporting companies and is consistent with the accounting for capital stock as discussed in Issue Paper No. 72—Statutory Surplus. Additionally, paragraph 19 of this issue paper requires disclosure of the existence and nature of any repurchase obligation. EITF 89-11 addresses the accounting for SEC reporting companies and is therefore rejected.

23. This issue paper is consistent with the reporting of ESOP debt as discussed in Issue Paper No. 80.

24. The conclusions above are consistent with the Statement of Concepts which states:

Objectives of Statutory Financial Reporting

The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

25. The P & C Accounting Practices and Procedures Manual, Chapter 13 and the Life/A&H Accounting Practices and Procedures Manual, Chapter 17 include the following guidance in (only the pertinent excerpts are included below):
Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP’s must record the debt obligations of such ESOP’s on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company’s stock, contributions from the company, or the sale or exchange of the company’s securities.

Generally Accepted Accounting Principles

26. SOP 93-6 provides the following guidance related to debt obligations of ESOPs (only the pertinent excerpts are included below):

Scope

1. This statement of position (SOP) provides guidance on employers’ accounting for employee stock ownership plans (ESOPs). It applies to all employers with ESOPs, both leveraged and nonleveraged. It does not address financial reporting by ESOPs.1

2. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

3. This SOP supersedes American Institute of Certified Public Accountants (AICPA) SOP 76-3, Accounting Practices for Certain Employee Stock Ownership Plans, and affects certain Emerging Issues Task Force (EITF) consensuses. A list of the documents affected is provided in appendix D of this SOP.

Background

4. SOP 76-3 was issued in December 1976, primarily to deal with accounting and reporting issues relevant to employers with leveraged ESOPs, and it has been the primary source of guidance on the subject.

5. Since the issuance of SOP 76-3, Congress has revised laws concerning ESOPs several times and the Internal Revenue Service (IRS) and the U.S. Department of Labor have issued many regulations covering the operation of plans, which actions have resulted in changes in the way ESOPs may operate and the reasons they are established by companies. Those changes, the most significant of which are described in Appendix C, were factors in the growth in the number of plans from fewer than 2,500 plans in 1976 to nearly 10,000 at the end of 1990.2

6. The increase in the number of ESOPs since the issuance of SOP 76-3 was matched by an increase in their complexity. It is no longer possible to describe a typical ESOP. ESOPs are used for many purposes in addition to furthering employee ownership, some of which were not contemplated when SOP 76-3 was issued. These include the following:

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1 Financial reporting by ESOPs is discussed in the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans.

2 Statistics from an unpublished study completed in 1991 by the National Center for Employer Ownership, Oakland, Calif.
• To fund a matching program for a sponsor’s 401(k) saving plan, formula-based profit-sharing plan, and other employee benefits
• To raise new capital or to create a marketplace for the existing stock
• To replace lost benefits from the termination of other retirement plans or provide benefits under postretirement benefit plans, particularly medical benefits
• To be part of the financing package in leveraged buy-outs
• To provide a tax-advantaged means for owners to terminate their ownership
• To be part of a long-term program to restructure the equity section of a plan sponsor’s balance sheet
• To defend the company against hostile takeovers

7. The borrowing arrangements used by leveraged ESOPs have also become more diverse. When SOP 76-3 was issued, most leveraged ESOPs borrowed from outside lenders, and the loan terms were relatively simple. Since then, internally leveraged ESOPs (ESOPs that borrow from the sponsor) have become more common. Furthermore, some ESOP loans are now structured so that a large portion of the debt service will be paid with dividends on shares held by the ESOP rather than with employer contributions.

8. Employers’ accounting for ESOP transactions, particularly the measurement of compensation cost and the treatment of dividends on shares held by an ESOP, has been a source of accounting controversy for many years. Even when SOP 76-3 was issued, there was disagreement about some ESOP issues. Changes in laws and regulations that apply to ESOPs and the increased diversity in the structure and purpose of ESOPs have called new attention to the limitations of SOP 76-3. Furthermore, SOP 76-3 does not address some of the accounting issues presented by the new ESOPs. Although the EITF has addressed a number of ESOP issues, it has done so on an ad hoc basis.

9. Therefore, the Accounting Standards Executive Committee (AcSEC) undertook this project to reconsider SOP 76-3 and to consider current ESOP issues that are not specifically addressed in the accounting literature. AcSEC’s objective in issuing this SOP is to enhance the relevance and representational faithfulness of financial statements of employers that sponsor ESOPs.

10. There are two basic forms of ESOP: nonleveraged and leveraged. This SOP addresses the financial reporting for each separately.

Conclusions

11. The following conclusions should be read in conjunction with the “Discussion of Conclusions” beginning with paragraph 59 of this SOP. That section explains considerations that were deemed significant by members of AcSEC in reaching the conclusions.

Leveraged ESOPs

12. Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer’s shares. The shares initially held by the ESOP in a suspense account are called suspense shares. The debt is generally repaid by the ESOP from employer contributions and dividends on the employer’s stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP’s fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without

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3 Paragraph 13 of SOP 76-3 presents a minority view that disagrees with that SOP’s recommendations on reporting dividends paid and earnings per share.
a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

4 Terms defined in the glossary are in italicized type the first time they appear in this SOP.

Reporting the Purchase of Shares by ESOPs

13. An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph 24).

Reporting the Release of ESOP Shares

14. ESOP shares are released for different purposes: to compensate employees directly, to settle employer liabilities for other employee benefits, and to replace dividends on allocated shares that are used for debt service. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged. Regardless of the account charged, the amount of the charge should be based on fair values5 of committed-to-be-released shares.

5 Paragraph 20 of this SOP contains guidance on fair value.

15. Under this SOP, when shares are committed to be released, rather than when shares are legally released, is significant for accounting purposes. That refinement was made in recognition of the fact that ESOP shares are legally released from an ESOP’s suspense account (and from serving as collateral for ESOP debt) when debt payments are made, but the employee service to which the shares released relates is continuous. Accordingly, for purposes of reporting compensation cost and satisfaction of liabilities under this SOP, accounting recognition should occur when shares are committed to be released, which may occur before the shares are legally released. Shares that have not been legally released, but that relate to employee services rendered during an accounting period (interim or annual) ending before the related debt service payment is made, should be considered committed to be released. The periods of employee service to which shares relate is generally specified in the ESOP documents.

16. Some employers establish ESOPs that are not linked to any other employee benefit or compensation promise; therefore, the ESOP shares directly compensate the employees. For ESOP shares committed to be released to compensate employees directly, the employer should recognize compensation cost equal to the fair value of the shares committed to be released. The shares generally should be deemed to be committed to be released ratably during an accounting period as the employees perform services, and, accordingly, average fair values should be used to determine the amount of compensation cost to recognize each reporting period (interim or annual). The amount of compensation cost recognized in previous interim periods should not be adjusted for subsequent changes in the fair value of shares.

17. Some employers agree to provide a specified or determinable benefit, such as a contribution to a 401(k) plan or to a formula profit-sharing plan, to employees and use the ESOP to partially or fully fund the benefit. Employers should recognize compensation cost and liabilities
associated with providing such benefits to employees in the same manner they would had an ESOP not been used to fund the benefit. For ESOP shares committed to be released to settle liabilities for such benefits, employers should report satisfaction of the liabilities when the shares are committed to be released to settle the liability. The number of shares released to settle the liability is based on the fair value of shares as of dates specified by the employers, which are usually specified in the ESOP documents.

18. The IRC allows employers to use dividends on ESOP shares that have been allocated to participants for debt service if participants are allocated shares of employer stock with a fair value no less than the amount of the dividends used for debt service. If shares released will include shares designated to replace dividends on previously allocated shares used for debt service, employers should report the settlement of the dividend payable when the shares are committed to be released to replace the dividends on shares used for debt service. (See paragraphs 21 and 22; only dividends on allocated shares should be charged to retained earnings.) The number of shares committed to be released to replace the dividends on allocated shares used for debt service is based on the fair value of shares as of dates specified by the employer, which are usually specified in the ESOP documents based on the employer’s interpretation of current IRS regulations.

19. Unearned ESOP shares should be credited as shares are committed to be released based on the cost of the shares to the ESOP. Employers should charge or credit the difference between the fair value of shares committed to be released and the cost of those shares to the ESOP to shareholders’ equity in the same manner as gains and losses on sales of treasury stock (generally to additional paid-in capital).

Fair Value

20. The fair value of ESOP shares is needed to apply certain provisions of this SOP. The fair value of an ESOP share is the amount the seller could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale. For shares that are traded, the price in the most active market should be used to measure fair value. If there is no market price, the employer’s best estimate of fair value should be used. The use of independent experts may be necessary to estimate fair value. For example, the amount determined in a recent (within twelve months of the employer’s year-end) independent stock valuation report may aid in determining the best estimate of fair value.

Reporting Dividends on ESOP Shares

21. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes. Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost.

22. Dividends on allocated shares should be charged to retained earnings. The dividends payable may be satisfied either by contributing cash to the participant accounts, by contributing additional shares to participant accounts, or by releasing shares from the ESOP’s suspense account to participant accounts (see paragraph 18).

Reporting Redemptions of ESOP Shares

23. Regardless of whether an ESOP is leveraged of nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts. Employers should report the satisfaction of such option exercises as purchases of treasury stock.
Reporting of Debt and of Interest

24. For purposes of applying this SOP, ESOP debt is characterized as follows:

- **Direct loan** — A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- **Indirect loan** — A loan made by the employer to the ESOP, with a related outside loan to the employer.
- **Employer loan** — A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

25. Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

26. Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer's financial statements.

27. Employers that sponsor an ESOP with an employer loan should not report the ESOP’s note payable and the employer’s note receivable in the employer’s balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Earnings per Share

28. For purposes of computing primary and fully diluted earnings per share (EPS), ESOP shares that have been committed to be released should be considered outstanding. ESOP shares that have not been committed to be released should not be considered outstanding.

29. Employers with ESOPs that hold convertible preferred stock may encounter unique EPS issues. The remainder of this section provides guidance on how to deal with some of those issues, particularly the following:

- Whether convertible preferred shares held by an ESOP should be considered common stock equivalents
- How to determine the number of shares assumed to be outstanding in the if-converted EPS computations
- How earnings applicable to common stock in if-converted EPS computations should be adjusted for dividends on allocated shares used for debt service
- Whether prior periods’ EPS should be restated for changes in conversion rates

This SOP does not provide a step-by-step discussion of how to apply the if-converted method to compute EPS and does not address all possible EPS questions that may arise. Accounting Principles Board (APB) Opinion No. 15, *Earnings per Share*; the AICPA's accounting Interpretations of that Opinion; and illustrations 4 and 5 in appendix A of this SOP provide additional guidance.
30. **Common Stock Equivalents.** APB Opinion No. 15 requires that a convertible security, which at the time of issuance has terms that make it for all practical purposes substantially the equivalent to a common stock, should be regarded as a common stock equivalent. For convertible preferred stock not held by an ESOP, an effective yield test is applied to the securities at the time of issuance to determine whether the securities should be considered common stock equivalents. However, the terms of convertible preferred shares held by ESOPs generally differ from other convertible preferred stock in two ways:

a. Convertible preferred shares held by ESOPs generally cannot remain outstanding indefinitely.

b. ESOP participants cannot withdraw their convertible preferred shares from the plan; the terms generally require participants to redeem the shares with the employer or convert the shares to common stock when participants withdraw their account balances from the ESOP plan. (Whether a participant chooses redemption or conversion depends on the value of the employer’s common stock in relation to the stated minimum value of the convertible preferred stock.)

ESOP shares with such characteristics should always be considered common stock equivalents. However, if the convertible preferred shares held by an ESOP may be withdrawn from the plan and sold to someone other than the employer or other ESOP participants, the employer should apply the effective yield test to determine whether the shares should be considered common stock equivalents.

31. **Number of Shares Outstanding.** Under this SOP, ESOP shares are not considered outstanding until they are committed to be released. For ESOP shares considered common stock equivalents, the number of common shares that would be issued on conversion of the convertible shares held by an ESOP that have been committed to be released should be deemed outstanding in the if-converted EPS computations for both primary and fully diluted EPS if the effect is dilutive. Convertible preferred shares held by the ESOP that have not been committed to be released should not be considered outstanding and, accordingly, would be excluded from the if-converted computations for both primary and fully diluted EPS.

32. When participants withdraw account balances containing convertible preferred shares from an ESOP, they may be entitled to receive common shares or cash with a value equal to either the fair value of the convertible preferred shares of a stated minimum value per share. Accordingly, if the value of the common stock issuable is less than the stated minimum value or the fair value of the preferred, participants may receive common shares or cash with a value greater than the value of the common shares issuable at the stated conversion rate. In determining EPS, the employer should presume that such a shortfall will be made up with shares of common stock. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash. In applying the if-converted method, the number of common shares issuable on assumed conversion, which should be included in the denominator of the EPS calculation, should be the greater of (a) the shares issuable at the stated conversion rate and (b) the shares issuable if the participants were to withdraw the shares from their accounts. Shares issuable on assumed withdrawal should be computed for primary earnings based on the ratio of (a) the average fair value of the convertible stock or, if greater, its stated minimum value, to (b) the average fair value of the common stock. For fully diluted EPS, the ratio should be (a) the end-of-period fair value of the convertible stock or, if greater, the stated minimum value, to (b) the end-of-period value of the common stock, if that ratio is more dilutive than the primary EPS ratio. The appropriate ratios should then be applied to the shares issuable at the state conversion rate to determine the number of shares issuable on assumed withdrawal.

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6 Financial Accounting Standards Board (FASB) Interpretation No. 31, *Treatment of Stock Compensation Plan in EPS Computations*, used such a presumption for stock appreciation rights and other variable plan awards.
33. **Adjustments to Earnings.** Employers that use dividends on allocated ESOP shares to pay debt service should adjust earnings applicable to common shares in the if-converted computation for the difference (net of income taxes) between the amount of compensation cost reported and the amount of compensation cost that would have been reported if the allocated shares had been converted to common stock at the beginning of the period.

34. **Changes in Conversion Rates.** In consonance with paragraphs 56 through 58 of APB Opinion 15, prior period EPS should not be restated for changes in the conversion rates.

**Accounting for Terminations**

35. Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

36. If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring an ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

37. If the ESOP sells the suspense shares and used the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement of Financial Accounting Standards No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, requires that difference to be included in the employer’s income when the debt is extinguished.

38. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

39. If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs 14 to 18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

**Nonleveraged ESOPs**

40. An employer with a nonleveraged ESOP periodically contributes its shares or cash to its ESOP on behalf of employees. The shares contributed or acquired with the cash contributed, which may be outstanding shares, treasury shares, or newly issued shares, are allocated to participant accounts and held by the ESOP until distributed to the employees at a future date, such as on the date of termination or retirement. The shares of employer stock obtained by the nonleveraged ESOP must be allocated to individual participant accounts as of the end of the ESOP’s fiscal year.
Reporting Purchase of Shares by ESOPs

41. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Compensation cost should be measured as the fair value of the shares contributed to or committed to be contributed to the ESOP or as the cash contributed to or committed to be contributed to the ESOP, as appropriate under the terms of the plan.

Reporting Dividends on ESOP Shares

42. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Reporting Redemptions of ESOP Shares

43. Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires the employer to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts, which on exercise requires the employer to repurchase the shares at fair value. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Earnings per Share

44. All shares held by a nonleveraged ESOP should be treated as outstanding in computing the employer’s EPS, except the suspense account shares of a pension reversion ESOP, which should not be treated as outstanding until they are committed to be released for allocation to participant accounts. If a nonleveraged ESOP holds convertible preferred stock, the guidance in paragraphs 29 to 34 of this SOP for leveraged ESOPs should be considered.

Pension Reversion ESOPs

45. An employer that terminates a defined benefit pension plan may avoid part of the excise tax on an asset reversion by transferring the assets to an existing or newly created ESOP, which could be either leveraged or nonleveraged. The reverted assets may be used either to purchase shares of the employer stock or to retire existing ESOP debt.

46. If the assets from the pension plan are used by the ESOP to purchase employer shares, the employer should report the share issuance the same way as other share issuances to an ESOP. The issuance of shares or the sale of treasury shares to the ESOP should be recognized when it occurs, and a corresponding charge to unearned ESOP shares, a contra-equity account, should be reported. If the shares are purchased on the market, the employer should similarly charge unearned ESOP shares. (The credit would be to cash.)

47. Because the number of shares the ESOP acquires in a pension plan reversion is usually more than the IRS permits to be allocated to participant accounts in a single year, some of the shares are held in a suspense account until they are committed to be released in future years for allocation to participant accounts. The guidance in this SOP, for shares held by leveraged ESOPs, should be applied to suspense account shares.

48. If the assets from the pension plan reversion are used to repay the debt of an existing ESOP, ESOP shares are committed to be released from suspense. In such situations, the guidance for leveraged ESOPs in this SOP should be followed. The employer should reduce the debt as it is repaid and reduce unearned ESOP shares as shares are committed to be released. How the committed-to-be-released shares are used determines what accounts are charged upon release of shares (see paragraphs 14 to 18).
Issues Related to Accounting for Income Taxes

Leveraged ESOPs

49. For employers with leveraged ESOPs, the amount of ESOP-related expense reported under this SOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result if (a) the fair value of shares committed to be released differs from the cost of those shares to the ESOP and (b) the timing of expense recognition is different for income tax and financial reporting purposes. Such differences should be reported in accordance with FASB Statement No. 109, Accounting for Income Taxes. Similar differences arise from employee stock options. Paragraph 36e of Statement No. 109 requires that the tax effects of expenses for employee stock options recognized differently for financial reporting and tax purposes be recognized in the related component of shareholders’ equity.

50. In accordance with paragraph 36e of Statement No. 109, if the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders’ equity. Conversely, if the cost of shares committed to be released is less than their fair value, the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders’ equity to the extent of previous credits to shareholders’ equity related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

51. Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations. Under paragraph 36f of FASB Statement No. 109, the tax benefit of tax-deductible dividends on unallocated ESOP shares that are charged to retained earnings should be credited to shareholders’ equity. However, because dividends on unallocated shares would not be charged to retained earnings under this SOP, paragraph 36f of Statement No. 109 would not apply to ESOP shares accounted for under this SOP.

Nonleveraged ESOPs

52. Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference under Statement No. 109.

Disclosures

53. An employer sponsoring an ESOP should disclose the following information about the plan, if applicable:

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used.

b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation, the classification of dividends on ESOP shares, and the treatment of ESOP shares for EPS computations. If the employer has both old ESOP shares for which it does not adopt the guidance in this SOP and new ESOP shares for which the guidance in the SOP is required (see paragraphs 54 and 55), the accounting policies for both blocks of shares shall be described.
c. The amount of compensation cost recognized during the period.

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance-sheet date. This disclosure should be made separately for shares accounted for under this SOP and for grandfathered ESOP shares (see paragraphs 54 and 55).

e. The fair value of unearned ESOP shares at the balance-sheet date for shares accounted for under this SOP. (Future tax deductions will be allowed only for the ESOP’s cost of unearned ESOP shares.) This disclosure need not be made for old ESOP shares for which the employer does not apply the guidance in this SOP (see paragraphs 55 and 56).

f. The existence and nature of any repurchase obligation, including disclosure of the fair value of the shares allocated as of the balance-sheet date, which are subject to a repurchase obligation.

See paragraph 20 for guidance on fair value.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 13, Other Liabilities
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 24—Discontinued Operations and Extraordinary Items
- Issue Paper No. 72—Statutory Surplus
- Issue Paper No. 80—Debt
- Issue Paper No. 83—Accounting for Income Taxes

Generally Accepted Accounting Principles
- AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans.
- FASB Emerging Issues Task Force Issue No. 89-11, Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan

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

Other Sources of Information
- Securities and Exchange Commission Codification of Financial Reporting Policies, Section 211 - Redeemable Preferred Stocks
Statutory Issue Paper No. 80

Debt

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for debt is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health (Life/A&H Accounting Practices and Procedures Manual) and for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance provides that debt be reported at the unpaid amount at the balance sheet date. Loans secured by mortgages on company real estate are treated as a reduction from the asset value of such real estate. Additionally, debt obligations of Employee Stock Ownership Plans (“ESOP”) must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities. See Issue Paper No. 41—Surplus Notes (Issue Paper No. 41) for discussion of surplus notes.

2. GAAP addresses accounting for debt in Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants (APB 14), Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables (APB 21), Accounting Principles Board Opinion No. 26, Early Extinguishment of Debt (APB 26), FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt (FAS 4), FASB Statement No. 47, Disclosure of Long Term Obligations (FAS 47), FASB Statement No. 76, Extinguishment of Debt (FAS 76), FASB Statement No. 84, Induced Conversions of Convertible Debt (FAS 84) and in AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans (SOP 93-6).

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

SUMMARY CONCLUSION

4. Debt shall be reported as a liability unless it is debt on real estate (i.e., reported as a reduction in the carrying value of real estate) in accordance with Issue Paper No. 40—Real Estate Investments (Issue Paper No. 40), or is offset against another asset in accordance with Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities (Issue Paper No. 76) or is specified elsewhere within the codification. Instruments that meet the requirements to be recorded as surplus as specified in Issue Paper No. 41—Notes, are not considered debt. Interest on debt shall be accrued over the life of the debt and charged to operations, except when capitalized in accordance with Issue Paper No. 44—Capitalization of Interest (Issue Paper No. 44). Interest payable shall include interest payable on all debt reported as a liability, approved interest on surplus notes and interest payable on debt reported as a reduction in the carrying value of real estate.

5. Debt discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Such discount or premium shall be amortized over the life of the note using the interest method.
6. Debt issuance costs (i.e., loan fees, legal fees, etc.) do not meet the definition of an asset as defined in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Accordingly, such costs shall be charged to operations.

7. Debt obligations of ESOPs shall be reported as borrowed money by company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities. ESOPs are addressed in Issue Paper No. 78—Employee Stock Ownership Plans.

8. Debt which is subject to a troubled debt restructuring shall be accounted for in accordance with Issue Paper No. 36—Troubled Debt Restructurings (Issue Paper No. 36).

9. Convertible debt securities that are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price not significantly in excess of the face amount shall be accounted for solely as debt at the time of issuance. An expense shall be recognized, equal to the fair value of additional securities granted or other consideration issued to induce conversion subsequent to the issuance of convertible debt securities.

10. Proceeds from debt issued with detachable stock purchase warrants shall be allocated based on the relative fair value of the two securities at the time of issuance. The value attributable to the warrants shall be accounted for as paid-in capital.

11. Other types of debt securities shall be accounted for in accordance with the substance of the transaction.

12. Debt shall be considered extinguished if the debtor is relieved of primary liability for the debt by the creditor and it is probable that the debtor will not be required to make future payments as guarantor of the debt. Even if the creditor does not relieve the debtor of its primary obligation, such debt shall be considered extinguished if the debtor irrevocably places cash or other monetary assets (that are essentially risk free as to the amount, timing, and collection of interest and principal) in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote. The monetary assets held by the trust shall provide cash flows (from interest and maturity of those assets) that approximately coincide, as to timing and amount, with the scheduled interest and principal payments on the debt that is being extinguished. Gains and losses from extinguishment of debt are capital gains or losses, and shall be charged to operations in accordance with Issue Paper No. 24—Discontinued Operations and Extraordinary Items (Issue Paper No. 24).

13. The financial statements or notes thereto shall disclose the following items related to debt:

- date issued;
- pertinent information concerning the kind of borrowing (e.g. debentures, commercial paper outstanding, bank loans, lines of credit, etc.);
- face amount of the debt;
- carrying value of debt;
- the rate at which interest accrues;
- the effective interest rate;
- the combined aggregate amount of maturities and sinking fund requirements for each of the five years following the latest balance sheet presented;
- collateral requirements;
- a summary of significant debt terms and covenants and any violations;
- interest paid in the current year;
• if debt was considered to be extinguished by in-substance defeasance prior to the effective date of this issue paper and any of the debt remains outstanding, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period; and
• if assets are set aside after the effective date of this issue paper solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

DISCUSSION

14. This issue paper adopts current statutory guidance for debt. It expands on current statutory guidance to address the accounting for debt discount and premium, debt issuance costs, convertible debt securities, debt issued with detachable stock purchase warrants and extinguishment of debt. It also expands current statutory guidance to address disclosure requirements regarding the carrying value of the debt, effective interest rate, combined aggregate amount of maturities and sinking fund requirements for each of the five years following the latest balance sheet presented and interest paid in the current year.

15. This issue paper adopts APB 14 and FAS 84. The requirement in paragraph 13 to disclose the aggregate amount of maturities and sinking fund requirements for each of the next five years is consistent with subparagraph 10b of FASB Statement No. 47, Disclosure of Long Term Obligations.

16. This issue paper adopts APB 21 with a modification to require that debt issuance costs be charged to operations. These costs represent deferred charges which are immediately expensed for statutory accounting, whereas GAAP requires that such costs be reported on the balance sheet as deferred charges and be recognized over the period of the borrowing as an adjustment to the effective interest rate. Immediately expensing debt issuance costs is consistent with the Statement of Concepts which states “Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment”.

17. This issue paper rejects FAS 4 and FASB Statement No. 64, Extinguishment of Debt Made to Satisfy Sinking Fund Requirements—an Amendment of FASB Statement No. 4. This issue paper also rejects FASB Emerging Issues Task Force No. 84-40, Long-Term Debt Repayable by a Capital Stock.

18. This issue paper adopts APB 26 with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations in accordance with Issue Paper No. 24. This issue paper adopts paragraphs 13 and 25 of SOP 93-6 with a modification to exclude debt obligations when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company’s stock, contributions from the company or the sale or exchange of the company’s securities. Such obligations do not meet the definition of liabilities (of the sponsor) as defined in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). This issue paper rejects paragraph 37 of SOP 93-6 as it relates to reporting gain and losses on extinguishment of debt. Such gains and losses shall be accounted for consistent with Issue Paper No. 24. SOP 93-6 will be addressed in its entirety in Issue Paper No. 78.

19. This issue paper adopts FASB Emerging Issues Task Force No. 90-19, Convertible Bonds with Issuer Option to Settle for Cash upon Conversion, with a modification to reject guidance related to earnings per share and FASB Technical Bulletin No. 80-1, Early Extinguishment of Debt through Exchange for Common or Preferred Stock, with a modification to reject guidance related to classification of the loss as an extraordinary item.
20. Additionally, this issue paper adopts the following pronouncements which clarify and/or provide guidance in certain circumstances (such pronouncements are not reproduced herein due to length and limited scope):

Accounting Principles Board Opinion No. 12, paragraphs 16 and 17, Omnibus Opinion – 1967
AICPA Accounting Interpretations of APB 21, Interest on Receivables and Payables
AICPA Accounting Interpretations of APB 26, Early Extinguishment of Debt
FASB Emerging Issues Task Force No. 85-9, Revenue Recognition on Options to Purchase Stock of Another Entity
FASB Emerging Issues Task Force No. 85-17, Accrued Interest upon Conversion of Convertible Debt
FASB Emerging Issues Task Force No. 85-29, Convertible Bonds with a “Premium Put”
FASB Emerging Issues Task Force No. 86-8, Sale of Bad-Debt Recovery Rights
FASB Emerging Issues Task Force No. 86-15, Increasing-Rate Debt
FASB Emerging Issues Task Force No. 86-18, Debtor’s Accounting for a Modification of Debt Terms
FASB Emerging Issues Task Force No. 86-28, Accounting Implications of Indexed Debt Instruments
FASB Emerging Issues Task Force No. 86-36, Invasion of a Defeasance Trust
FASB Emerging Issues Task Force No. 95-15, Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishement to Occur at a Future Date for a Specified Amount

21. This issue paper is consistent with the reporting for surplus notes as addressed in Issue Paper No. 41, the reporting of encumbrances on real estate as discussed in Issue Paper No. 40, the offsetting of assets and liabilities as addressed in Issue Paper No. 76 and the reporting of gains and losses on troubled debt restructurings as discussed in Issue Paper No. 36.

22. The conclusions above are consistent with the Statement of Concepts which states:

Objectives of Statutory Financial Reporting

The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

Drafting Notes/Comments
- Reverse repurchase agreements are addressed in Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements.
- Pledged assets are addressed in Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
23. The P & C Accounting Practices and Procedures Manual includes the following guidance in Chapter 13 (only the pertinent excerpts are included below):
Borrowed Money

Borrowed money includes liabilities for loans except those secured by mortgages on company real estate and surplus loans. The amount to be reported is the amount unpaid at the balance sheet date. Resolution authorizing borrowed money are usually shown in the minutes of the board of directors, executive, investment, or finance committees.

Loans secured by mortgages on company real estate are treated as a reduction from the asset value of such real estate rather than as “Borrowed Money.” For further discussion, see Chapter 4-Real Estate.

Surplus loans, i.e., subordinated surplus debentures, are covered in Chapter 24-Paid-In or Contributed Surplus.

Interest Payable

Interest payable includes interest on “Borrowed Money” as well as interest on real estate and surplus loans. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. Further treatment of funds held by a ceding company may be found in Chapter 22-Reinsurance.

The interest on “Borrowed Money” is also shown parenthetically as part of the caption of this liability item in the annual statement.

Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP’s must record the debt obligations of such ESOP’s on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company’s stock, contributions from the company, or the sale or exchange of the company’s securities.

24. The Life/A&H Accounting Practices and Procedures Manual includes the following guidance in Chapter 17 (only the pertinent excerpts are included below):

Borrowed Money

Borrowed money is debt, other than subordinated surplus debentures, contribution notes, or similar indebtedness. The amount to be reported is the amount unpaid at the balance sheet date plus the related accrued interest. See Chapter 27 for a discussion of subordinated surplus debentures, etc.

Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP’s must record the debt obligations of such ESOP’s on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company’s stock, contributions from the company, or the sale or exchange of the company’s securities.

25. The NAIC Annual Statement Instructions (Annual Statement Instructions) for Property and Casualty Insurance Companies provide the following guidance. Substantially similar guidance is provided in the Annual Statement Instructions for Life and Accident and Health Insurance Companies.

7. Borrowed Money

Instruction:

Furnish pertinent information concerning the kind of borrowing (e.g., debentures, commercial paper outstanding, bank loan, lines of credit, etc.). Indicate redemption price, if any, interest
features, collateral requirements, maturity date, etc., for money borrowed by the company. Also include information regarding material loan provisions (i.e., covenants) that must be satisfied or maintained on a continuing basis and indicate if the society is in violation of any such loan provisions. Identify the terms of reverse repurchase agreements whose amounts have been included in the liability for borrowed money.

**Generally Accepted Accounting Principles**

26. APB 14 provides the following guidance (only the pertinent excerpts are included below):

**CONVERTIBLE DEBT**

Discussion

3. Convertible debt securities discussed herein are those debt securities which are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at time of issuance, and (3) a conversion price which does not decrease except pursuant to antidilution provisions. In most cases such securities also are callable at the option of the issuer and are subordinated to nonconvertible debt.

7. The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa.

Opinion

12. The Board is of the opinion that no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph 3 should be accounted for as attributable to the conversion feature. In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph 7) and less weight on practical difficulties.
DEBT WITH STOCK PURCHASE WARRANTS

Opinion

16. The Board is of the opinion that the portion of the proceeds of debt securities issued with detachable stock purchase warrants which is allocable to the warrants should be accounted for as paid-in capital. The allocation should be based on the relative fair values of the two securities at time of issuance. Any resulting discount or premium on the debt securities should be accounted for as such. The same accounting treatment applies to issues of debt securities (issued with detachable warrants) which may be surrendered in settlement of the exercise price of the warrant. However, when stock purchase warrants are not detachable from the debt and the debt security must be surrendered in order to exercise the warrant, the two securities taken together are substantially equivalent to convertible debt and the accounting specified in paragraph 12 should apply.

2 The time of issuance generally is the date when agreement as to terms has been reached and announced, even though the agreement is subject to certain further actions, such as directors' or stockholders' approval. APB 14 Footnote 3

3 See Chapter 15 of ARB No. 43 (as amended by paragraph 19 of APB Opinion No. 6 and paragraph 17 of APB Opinion No. 9) and paragraphs 16 and 17 of APB Opinion No. 12.

17. When detachable warrants are issued in conjunction with debt as consideration in purchase transactions, the amounts attributable to each class of security issued should be determined separately, based on values at the time of issuance. The debt discount or premium is obtained by comparing the value attributed to the debt securities with the face amount thereof.

OTHER TYPES OF DEBT SECURITIES

Opinion

18. The Board recognizes that it is not practicable in this Opinion to discuss all possible types of debt with conversion features, debt issued with stock purchase warrants, or debt securities with a combination of such features. Securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction. For example, when convertible debt is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.
APB 21 provides the following guidance (only the pertinent excerpts are included below):

**Opinion**

15. Amortization of discount and premium. With respect to a note which by the provisions of this Opinion requires the imputation of interest, the difference between the present value and the face amount should be treated as discount or premium\(^8\) and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the “interest” method described in and supported by paragraphs 16 and 17 of APB Opinion No. 12, Omnibus Opinion--1967. However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the “interest” method.

\(^8\) Differences between the recognition for financial accounting purposes and income tax purposes of discount or premium resulting from determination of the present value of a note should be treated as timing differences in accordance with APB Opinion No. 11, Accounting for Income Taxes.

16. Statement presentation of discount and premium. The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount should also be disclosed in the financial statements or in the notes to the statements.\(^9\) Amortization of discount or premium should be reported as interest in the statement of income. Issue costs should be reported in the balance sheet as deferred charges.

\(^9\) Refer to the Appendix for illustrations of balance sheet presentation.

APB 26 provides the following guidance (only the pertinent excerpts are included below):

**Opinion**

19. Reduction of alternatives. The Board concludes that all extinguishments of debt before scheduled maturities are fundamentally alike. The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment.

20. Disposition of amounts. A difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item.\(^1\) The criteria in APB Opinion No. 9 should be used to determine whether the losses or gains are ordinary or extraordinary items. Gains and losses should not be amortized to future periods.

\(^1\) If upon extinguishment of debt, the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges should be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.
21. Convertible debt. The extinguishment of convertible debt before maturity does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount should be recognized currently in income in the period of extinguishment as losses or gains.

29. FAS 47 provides the following guidance (only the pertinent excerpts are included below):

10. The following information shall be disclosed for each of the five years following the date of the latest balance sheet presented:

   b. The combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings

30. FAS 84 provides the following guidance (only the pertinent excerpts are included below):

APPLICABILITY AND SCOPE

2. This Statement applies to conversions of convertible debt to equity securities pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. This Statement applies only to conversions that both (a) occur pursuant to changed conversion privileges that are exercisable only for a limited period of time and (b) include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted. The changed terms may involve reduction of the original conversion price thereby resulting in the issuance of additional shares of stock, issuance of warrants or other securities not provided for in the original conversion terms, or payment of cash or other consideration to those debt holders who convert during the specified time period. This Statement does not apply to conversions pursuant to other changes in conversion privileges or to changes in terms of convertible debt instruments that are different from those described in this paragraph.

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2 For purposes of this Statement, a conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt.

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STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Recognition of Expense upon Conversion

3. When convertible debt is converted to equity securities of the debtor pursuant to an inducement offer described in paragraph 2 of this Statement, the debtor enterprise shall recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The expense shall not be reported as an extraordinary item.

4. The fair value of the securities or other consideration shall be measured as of the date the inducement offer is accepted by the convertible debt holder. Normally this will be the date the debt holder converts the convertible debt into equity securities or enters into a binding agreement to do so.

31. SOP 93-6 provides the following guidance related to debt obligations of ESOPs (only the pertinent excerpts are included below):
Leveraged ESOPs

12. Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer’s shares. The shares initially held by the ESOP in a suspense account are called suspense shares. The debt is generally repaid by the ESOP from employer contributions and dividends on the employer’s stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP’s fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

Terms defined in the glossary are in italicized type the first time they appear in this SOP.

Reporting the Purchase of Shares by ESOPs

13. An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph 24).

Reporting of Debt and of Interest

24. For purposes of applying this SOP, ESOP debt is characterized as follows:

- **Direct loan** - A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- **Indirect loan** - A loan made by the employer to the ESOP, with a related outside loan to the employer.
- **Employer loan** - A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

25. Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

26. Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer’s financial statements.
27. Employers that sponsor an ESOP with an employer loan should not report the ESOP’s note payable and the employer’s note receivable in the employer’s balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Accounting for Terminations

35. Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

36. If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring a ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

37. If the ESOP sells the suspense shares and used the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, Early Extinguishment of Debt, as amended by FASB Statement of Financial Accounting Standards No. 4, Reporting Gains and Losses from Extinguishment of Debt, requires that difference to be included in the employer’s income when the debt in extinguished.

38. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

39. If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs 14 to 18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate and Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 4, Real Estate and Chapter 13, Other Liabilities
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 23—Property Occupied by the Company
- Issue Paper No. 24—Discontinued Operations and Extraordinary Items
- Issue Paper No. 36—Troubled Debt Restructurings
- Issue Paper No. 40—Real Estate Investments
- Issue Paper No. 41—Surplus Notes
- Issue Paper No. 44—Capitalization of Interest
- Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities

Generally Accepted Accounting Principles

- Accounting Principles Board Opinion No. 12, paragraphs 16 and 17, Omnibus Opinion – 1967
- Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants
- Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables
- Accounting Principles Board Opinion No. 26, Early Extinguishment of Debt
- FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt
- FASB Statement No. 47, Disclosure of Long Term Obligations
- FASB Statement No. 64, Extinguishment of Debt Made to Satisfy Sinking Fund Requirements—an Amendment of FASB Statement No. 4
- FASB Statement No. 84, Induced Conversions of Convertible Debt
- AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans
- AICPA Accounting Interpretations of APB 21, Interest on Receivables and Payables
- AICPA Accounting Interpretations of APB 26, Early Extinguishment of Debt
- FASB Emerging Issues Task Force No. 84-40, Long-Term Debt Repayable by a Capital Stock
- FASB Emerging Issues Task Force No. 85-9, Revenue Recognition on Options to Purchase Stock of Another Entity
- FASB Emerging Issues Task Force No. 85-17, Accrued Interest upon Conversion of Convertible Debt
- FASB Emerging Issues Task Force No. 85-29, Convertible Bonds with a “Premium Put”
- FASB Emerging Issues Task Force No. 86-8, Sale of Bad-Debt Recovery Rights
- FASB Emerging Issues Task Force No. 86-15, Increasing-Rate Debt
- FASB Emerging Issues Task Force No. 86-18, Debtor’s Accounting for a Modification of Debt Terms
- FASB Emerging Issues Task Force No. 86-28, Accounting Implications of Indexed Debt Instruments
- FASB Emerging Issues Task Force No. 86-36, Invasion of a Defeasance Trust
- FASB Emerging Issues Task Force No. 90-19, Convertible Bonds with Issuer Option to Settle for Cash upon Conversion
- FASB Emerging Issues Task Force No. 95-15, Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount
- FASB Technical Bulletin No. 80-1, Early Extinguishment of Debt through Exchange for Common or Preferred Stock

State Regulations

- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 81

Foreign Currency Transactions and Translations

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A foreign currency transaction is a transaction denominated in a currency other than the reporting entity’s functional currency. The reporting entity’s functional currency is defined as the currency of the primary economic environment in which the reporting entity operates. Foreign currency translation is the translation of financial statements, denominated in the reporting entity’s functional currency, into U.S. dollars prior to their incorporation into financial statements through consolidation or the equity method of accounting.

2. Current statutory guidance for accounting for foreign currency transactions is provided in Chapters 13 and 25 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) and Chapter 8 of the Accounting Practices and Procedures Manual for Life, Accident, and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). This guidance requires foreign currency transactions to be recorded in U.S. dollars at the exchange rate in effect at the time of the transaction. At each subsequent statement date, all net assets recorded in each foreign currency are converted to U.S. dollars at the exchange rate in effect at the statement date. Property and casualty insurers record a change in net assets due to changes in foreign exchange rates between the original transaction date and the current statement date as an additional and separate asset or liability with a corresponding adjustment made directly to surplus. Life and accident and health insurers record an additional and separate asset or liability with a corresponding entry to capital gain or loss.

3. Limited statutory guidance for accounting for foreign currency transactions is also provided in the Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO Purposes and Procedures). This guidance requires that market values for securities payable in other than U.S. dollars to be computed by obtaining a quotation in the foreign currency from a reputable source and converting that quotation into U.S. dollars using the exchange rates published in the Valuation of Securities Manual.

4. GAAP guidance for accounting for foreign currency transactions is provided in FASB Statement No. 52, Foreign Currency Translation (FAS 52). This guidance requires each asset, liability, revenue, expense, gain, or loss arising from a transaction to be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date. Subsequently, at each balance sheet date, assets and liabilities that are denominated in a currency other than the functional currency of the recording entity are adjusted to reflect the current exchange rate. Any changes in the assets or liabilities from the date of the original transaction to the balance sheet date resulting from exchange rate fluctuations, are included in net income for the period in which the change occurred.

5. GAAP guidance for accounting for foreign currency translation is also provided in FAS 52. This guidance requires all assets and liabilities to be translated at the exchange rate at the balance sheet date, while revenues, expenses, gains, and losses are translated at the exchange rate in effect at the dates on which the transactions were recognized. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements.
6. The purpose of this issue paper is to establish statutory accounting principles for accounting for foreign currency transactions and translation that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

7. For the purposes of this issue paper, a U.S. domiciled entity’s reporting currency shall be defined as the U.S. dollar, regardless of the primary economic environment in which the reporting entity operates. In order to ensure consistency, all elements of statutory financial statements shall be reported in U.S. dollars.

8. Each foreign currency transaction shall be examined and a determination made if the foreign currency transaction was made in support of insurance operations denominated in the same foreign currency. For example, some reporting entities engage in operations in foreign countries with the premiums collected and claims paid in local currency. As in any insurance operation there will at times be uncollected premiums, policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the reporting entity’s balance sheet. Premiums, reserves, and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the claim is incurred. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars.

9. Foreign currency transactions made in support of insurance operations denominated in the same foreign currency, such as foreign branches, shall be accounted for as follows:

   a. Canadian Insurance Operations

      Canadian insurance operations, resulting in less than 10% of the reporting entity’s admitted assets, less than 10% of the reporting entity’s liabilities and less than 10% of the reporting entity’s net premium, can be translated to U.S. dollars by making an adjustment to the net assets of the foreign operation. The adjustment is calculated by summarizing the assets and liabilities in the foreign currency and in U.S. dollars. The net value is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the reporting entity. Any difference in the net value to current exchange rates is recorded as a separate asset or liability and the change in the foreign exchange adjustment is recorded as an unrealized capital gain or loss.

   b. All Other Foreign Insurance Operations

      All other foreign insurance operations must be translated to U.S. dollars as follows: each financial statement line shall be translated to U.S. dollars by applying the following exchange rates: 1) for assets and liabilities, the exchange rate at the balance sheet date shall be used and 2) for revenues, expenses, gains, losses and surplus adjustments, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, losses and surplus adjustments are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. Gains or losses due to translating foreign operations to U.S. dollars shall be recorded as an unrealized capital gain or loss.
10. All other foreign currency transactions shall be accounted for as follows:
   
a. Assets and liabilities denominated in foreign currencies shall be accounted for at their U.S. dollar equivalent values using exchange rates at the balance sheet date. Income and expenses recognized during an accounting period shall be recorded at an appropriately weighted average exchange rate.

b. Changes in balance sheet asset and liability values due to fluctuations in foreign currency exchange rates shall be recorded as unrealized capital gains and losses until the asset is sold or exchanged or the liability is settled. Upon settlement, previously recorded unrealized capital gains and losses shall be reversed and the foreign exchange profit or loss for the entire holding period shall be recorded as a realized capital gain or loss.

c. Transactions involving settlement in cash, such as purchases, payment of expenses, sales, and receipt of income, shall be recorded at their U.S. dollar equivalent value based on the foreign currency exchange rate as of the transaction date. Any foreign currency exchange gains or losses on purchases, payment of expenses, sales, maturities or changes in income or expense accruals should be recorded as capital gain or loss realized on the purchase, sale or maturity.

11. Nominal information such as par value of investments may be expressed in the foreign currency or U.S. dollar equivalent (description of issue), but where the information is displayed comparatively (column of par values), U.S. dollar equivalent amount should be used. The U.S. dollar equivalent amount is translated utilizing the exchange rate at the balance sheet date. Ratios and factors should be based on data that is entirely consistent with respect to currency.

12. A currency in a highly inflationary environment (one that has cumulative inflation of approximately 100% or more over a three year period) is not considered stable enough to serve as a functional currency and the more stable currency of the reporting parent is to be used instead. If a reporting entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. The remeasurement process is intended to produce the same result as if the reporting entity's books of record had been maintained in the functional currency. The remeasurement of and subsequent accounting for transactions denominated in a currency other than the functional currency shall be recognized as a realized gain or loss in the statement of operations.

DISCUSSION

13. This issue paper rejects current statutory accounting principles. Current statutory guidance for property and casualty insurers provides that fluctuations in the value of assets and liabilities be summarized and recorded as a net asset or liability with an offsetting adjustment made directly to surplus. Current statutory guidance for life and accident and health insurers provides that fluctuations in the values of assets and liabilities be summarized and recorded as a net asset or liability with a corresponding entry recorded as a capital gain or loss. The conclusions reached in this issue paper require all assets and liabilities to be translated at the exchange rate in effect at the balance sheet date with the corresponding entry recorded as an unrealized gain or loss (see paragraph 14 for reference to exemption for certain Canadian branch operations). This change to require life and accident and health insurers to reflect the translation gain or loss as unrealized was made to conform accounting treatment for the translation adjustment between property and casualty insurers and life and health insurers. Requiring all assets and liabilities to be translated at the exchange rate in effect at the balance sheet date provides more meaningful information to regulators and other financial statement users. The statutory principles outlined in the conclusion above are consistent with draft statutory guidance prepared by the Invested Assets Working Group of the Valuation of Securities (EX4) Task Force.
14. Subparagraph 9 a. of this issue paper affords different treatment to certain Canadian branch operations. As a matter of historic practice, U.S. reporting entities have treated Canadian branch operations in their statutory statements as if they were U.S. dollar denominated operations. This practice was established at a time when the Canadian and U.S. dollars were at or close to equivalent. The cost of translating each line item for immaterial Canadian operations is perceived to exceed the benefits of line-by-line exactness. Consideration has also been given to the impact on risk-based capital and the asset valuation reserve of reporting entities under the provisions of subparagraph 9 a. and the impact is not considered to be material.

15. The statutory principles outlined in the conclusion above are not consistent with current GAAP as follows:

a. Subparagraph 9 a. Allows changes in balance sheet asset and liability values due to exchange rate fluctuations of a reporting entity’s Canadian insurance operations comprising less than 10% of the reporting entity’s admitted assets and liabilities and net premium to be recorded as unrealized capital gains or losses with a corresponding adjustment made to a net asset or liability. GAAP requires each asset and liability account to be adjusted.

b. Paragraph 10 allows changes in balance sheet asset and liability values due to exchange rate fluctuations to be recorded as unrealized capital gains or losses. GAAP requires that fluctuations in asset values that arose as a result of transactions denominated in a foreign currency be recorded as part of net income. GAAP requires that a gain or loss resulting from translating the financial statements of an operation that has a functional currency other than the U.S. dollar be recorded as unrealized. Recording gains and losses as a result of fluctuations in exchange rates as unrealized gains and losses for statutory purposes affords these fluctuations the same accounting treatment as fluctuations in the market values of equity securities.


16. The statutory principles outlined in the conclusion above are consistent with the recognition and consistency concepts in the Statement of Concepts. Pertinent excerpts follow:

Consistency
The regulators’ need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles.

Recognition
The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise.
Drafting Notes/Comments
- Forward exchange contracts are addressed in a separate issue paper.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting
17. The P&C Accounting Practices and Procedures Manual, Chapter 13, Other Liabilities, provides the following guidance:

Net Adjustments in Assets and Liabilities Due to Foreign Exchange Rates

An insurance company may have assets or liabilities payable in foreign currencies. Differences between the exchange rates when the original entries were recorded and the current statement date result in changes in net asset value. Reductions in net asset value are shown under this caption, while increases are recorded as an asset under aggregate write-ins for other than invested assets. If different foreign currencies are involved, the assets and liabilities must be segregated accordingly and applied against the proper exchange rate. The exchange rates to be used are those published in the NAIC Valuation of Securities manual.

18. The P&C Accounting Practices and Procedures Manual, Chapter 25, Unassigned Funds (Surplus) provides the following guidance with respect to foreign exchange adjustments:

Change in Foreign Exchange Adjustment

Assets and liabilities in foreign currency are subject to adjustment to the prevailing foreign exchange rate. The change in the foreign exchange adjustment between the current and prior statement is charged or credited directly to unassigned surplus. (See Chapter 13-Other Liabilities.)

19. The Life/A&H Accounting Practices and Procedures Manual, Chapter 8, Other Admitted Assets, provides the following guidance:

Foreign Exchange Adjustment

Some insurers engage in operations in foreign countries, with the premiums collected and claims paid in the local currency. As in any insurance operations there will at all times be uncollected premiums, policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the insurer’s balance sheet in the annual statement.

For ease in maintaining policy records, the premiums, reserves and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the company receives notification of the claim. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars. Because of the constant fluctuations in the foreign currencies’ exchange rates, it may be confusing and unduly burdensome to adjust individual policy and claims records to current rates. Most companies, therefore, make such adjustment to the net balance of the assets and liabilities in each foreign currency.

The adjustment is calculated by summarizing the assets and liabilities in each foreign currency and in U.S. dollars, as recorded in the company’s policy and claim records. The net value in the foreign currency is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the company. Any difference in adjustment of the net value to current exchange rates is recorded as a separate asset or liability if the current rate is greater or less than the rate used by the company.

Change in foreign exchange adjustments generally are reported as capital gain or loss.
20. The SVO Purposes and Procedures Manual, Section 1, provides the following guidance:

Market values for securities payable in other than U.S. dollars will be computed by obtaining a quotation in the foreign currency from a reputable source and converting that quotation into U.S. dollars using the exchange rates published in the VOS Manual.

Generally Accepted Accounting Principles

21. FAS 52 provides the following guidance:

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Objectives of Translation

4. Financial statements are intended to present information in financial terms about the performance, financial position, and cash flows of an enterprise. For this purpose, the financial statements of separate entities within an enterprise, which may exist and operate in different economic and currency environments, are consolidated and presented as though they were the financial statements of a single enterprise. Because it is not possible to combine, add, or subtract measurements expressed in different currencies, it is necessary to translate into a single reporting currency those assets, liabilities, revenues, expenses, gains, and losses that are measured or denominated in a foreign currency. However, the unity presented by such translation does not alter the underlying significance of the results and relationships of the constituent parts of the enterprise. It is only through the effective operation of its constituent parts that the enterprise as a whole is able to achieve its purpose. Accordingly, the translation of the financial statements of each component entity of an enterprise should accomplish the following objectives:

   a. Provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity
   b. Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with U.S. generally accepted accounting principles

2 For convenience, this Statement assumes that the enterprise uses the U.S. dollar (dollar) as its reporting currency. However, a currency other than the dollar may be the reporting currency in financial statements that are prepared in conformity with U.S. generally accepted accounting principles. For example, a foreign enterprise may report in its local currency in conformity with U.S. generally accepted accounting principles. If so, the requirements of this Statement apply.

3 To measure in foreign currency is to quantify an attribute of an item in a unit of currency other than the reporting currency. Assets and liabilities are denominated in a foreign currency if their amounts are fixed in terms of that foreign currency regardless of the exchange rate changes. An asset or liability may be both measured and denominated in one currency, or it may be measured in one currency and denominated in another. To illustrate: Two foreign branches of a U.S. Company, one Swiss and one German, purchase identical assets on credit from a Swiss vendor at identical prices stated in Swiss francs. The German branch measures the cost (an attribute) of that asset in German marks. Although the corresponding liability is also measured in marks, it remains denominated in Swiss francs since the liability must be settled in a specific number of Swiss francs. The Swiss branch measures the asset and liability in Swiss francs. Its liability is both measured and denominated in Swiss francs. Although assets and liabilities can be measured in various currencies, rights to receive or obligations to pay fixed amounts of a currency are, by definition, denominated in that currency.

The Functional Currency

5. The assets, liabilities, and operations of a foreign entity shall be measured using the functional currency of that entity. An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. Appendix A provides guidance for determination of the functional currency. The economic factors cited in Appendix A,
and possibly others, should be considered both individually and collectively when determining the functional currency.

6. For an entity with operations that are relatively self-contained and integrated within a particular country, the functional currency generally would be the currency of that country. However, a foreign entity's functional currency might not be the currency of the country in which the entity is located. For example, the parent's currency generally would be the functional currency for foreign operations that are a direct and integral component or extension of the parent company's operations.

7. An entity might have more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. If those operations are conducted in different economic environments, they might have different functional currencies.

8. The functional currency (or currencies) of an entity is basically a matter of fact, but in some instances the observable facts will not clearly identify a single functional currency. For example, if a foreign entity conducts significant amounts of business in two or more currencies, the functional currency might not be clearly identifiable. In those instances, the economic facts and circumstances pertaining to a particular foreign operation shall be assessed in relation to the Board's stated objectives for foreign currency translation (paragraph 4). Management's judgment will be required to determine the functional currency in which financial results and relationships are measured with the greatest degree of relevance and reliability.

9. Once the functional currency for a foreign entity is determined, that determination shall be used consistently unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. Previously issued financial statements shall not be restated for any change in the functional currency.

10. If an entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. If a foreign entity's functional currency is the reporting currency, remeasurement into the reporting currency obviates translation. The remeasurement process is intended to produce the same result as if the entity's books of record had been maintained in the functional currency. The remeasurement of and subsequent accounting for transactions denominated in a currency other than the functional currency shall be in accordance with the requirements of this Statement (paragraphs 15 and 16). Appendix B provides guidance for remeasurement into the functional currency.

The Functional Currency in Highly Inflationary Economies

11. The financial statements of a foreign entity in a highly inflationary economy shall be remeasured as if the functional currency were the reporting currency. Accordingly, the financial statements of those entities shall be remeasured into the reporting currency according to the requirements of paragraph 10. For the purposes of this requirement, a highly inflationary economy is one that has cumulative inflation of approximately 100 percent or more over a 3-year period.

Translation of Foreign Currency Statements

12. All elements of financial statements shall be translated by using a current exchange rate. For assets and liabilities, the exchange rate at the balance sheet date shall be used. For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements.
13. If an entity's functional currency is a foreign currency, translation adjustments result from the process of translating that entity's financial statements into the reporting currency. Translation adjustments shall not be included in determining net income but shall be reported separately and accumulated in a separate component of equity.

14. Upon sale or upon complete or substantially complete liquidation of an investment in a foreign entity, the amount attributable to that entity and accumulated in the translation adjustment component of equity shall be removed from the separate component of equity and shall be reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs.

Foreign Currency Transactions

15. Foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid. A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes. Likewise, a transaction gain or loss (measured from the transaction date or the most recent intervening balance sheet date, whichever is later) realized upon settlement of a foreign currency transaction generally shall be included in determining net income for the period in which the transaction is settled. The exceptions to this requirement for inclusion in net income of transaction gains and losses are set forth in paragraphs 20 and 21 and pertain to certain intercompany transactions and to transactions that are designated as, and effective as, economic hedges of net investments and foreign currency commitments.

16. For other than forward exchange contracts (paragraphs 17-19), the following shall apply to all foreign currency transactions of an enterprise and its investees:

   a. At the date the transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date (paragraphs 26-28).

   b. At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity shall be adjusted to reflect the current exchange rate.

Transaction Gains and Losses to Be Excluded from Determination of Net Income

20. Gains and losses on the following foreign currency transactions shall not be included in determining net income but shall be reported in the same manner as translation adjustments (paragraph 13):

   a. Foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date

   b. Intercompany foreign currency transactions that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting enterprise's financial statements

21. A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction (for example, the purchase or the sale of the equipment). Losses shall not
be deferred, however, if it is estimated that deferral would lead to recognizing losses in later periods. A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:

a. The foreign currency transaction is designated as, and is effective as, a hedge of a foreign currency commitment.

b. The foreign currency commitment is firm.

The required accounting shall commence as of the designation date. The portion of a hedging transaction that shall be accounted for pursuant to this paragraph is limited to the amount of the related commitment. If a hedging transaction that meets conditions (a) and (b) above exceeds the amount of the related commitment, the gain or loss pertaining to the portion of the hedging transaction in excess of the commitment shall be deferred to the extent that the transaction is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized; consequently, it shall not be included in the aggregate transaction gain or loss disclosure required by paragraph 30. A gain or loss pertaining to the portion of a hedging transaction in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be deferred. If a foreign currency transaction previously considered a hedge of a foreign currency commitment is terminated before the transaction date of the related commitment, any deferred gain or loss shall continue to be deferred and accounted for in accordance with the requirements of this paragraph.

Exchange Rates

26. The exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. If exchangeability between two currencies is temporarily lacking at the transaction date or balance sheet date, the first subsequent rate at which exchanges could be made shall be used for purposes of this Statement. If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the enterprise shall be carefully considered (ARB 43, Chapter 12, paragraph 8).

27. The exchange rates to be used for translation of foreign currency transactions and foreign currency statements are as follows:

a. Foreign Currency Transactions - The applicable rate at which a particular transaction could be settled at the transaction date shall be used to translate and record the transaction. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date.

b. Foreign Currency Statements - In the absence of unusual circumstances, the rate applicable to conversion of a currency for purposes of dividend remittances shall be used to translate foreign currency statements.\(^4\)

\[^4\] If unsettled intercompany transactions are subject to and translated using preference or penalty rates, translation of foreign currency statements at the rate applicable to dividend remittances may cause a difference between intercompany receivables and payables. Until that difference is eliminated by settlement of the intercompany transaction, the difference shall be treated as a receivable or payable in the enterprise's financial statements.

28. If a foreign entity whose balance sheet date differs from that of the enterprise is consolidated or combined with or accounted for by the equity method in the financial statements of the enterprise, the current rate is the rate in effect at the foreign entity's balance sheet date for purposes of applying the requirements of this Statement to that foreign entity.
Use of Averages or Other Methods of Approximation

29. Literal application of the standards in this Statement might require a degree of detail in record keeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Accordingly, it is acceptable to use averages or other methods of approximation. For example, the propriety of using average rates to translate revenue and expense amounts is noted in paragraph 12. Likewise, the use of other time-and effort-saving methods to approximate the results of detailed calculations is permitted.

Disclosure

30. The aggregate transaction gain or loss included in determining net income for the period shall be disclosed in the financial statements or notes thereto. For that disclosure, gains and losses on forward contracts determined in conformity with the requirements of paragraphs 18 and 19 shall be considered transaction gains or losses. Certain enterprises, primarily banks, are dealers in foreign exchange. Although certain gains or losses from dealer transactions may fit the definition of transaction gains or losses in this Statement, they may be disclosed as dealer gains or losses rather than as transaction gains or losses.

31. An analysis of the changes during the period in the separate component of equity for cumulative translation adjustments shall be provided in a separate financial statement, in notes to the financial statements, or as part of a statement of changes in equity. At a minimum, the analysis shall disclose:

   a. Beginning and ending amount of cumulative translation adjustments
   b. The aggregate adjustment for the period resulting from translation adjustments (paragraph 13) and gains and losses from certain hedges and intercompany balances (paragraph 20)
   c. The amount of income taxes for the period allocated to translation adjustments (paragraph 24)
   d. The amounts transferred from cumulative translation adjustments and included in determining net income for the period as a result of the sale or complete or substantially complete liquidation of an investment in a foreign entity (paragraph 14)

32. An enterprise's financial statements shall not be adjusted for a rate change that occurs after the date of the enterprise's financial statements or after the date of the foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the financial statements of the enterprise. However, disclosure of the rate change and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary.

OTHER SOURCES OF INFORMATION

22. The Invested Assets Working Group of the Valuation of Securities (EX4) Task Force presented the following draft guidance to the Blanks Task Force:

   Attachment A

   NAIC ACCOUNTING PRINCIPLES
   ACCOUNTING FOR INVESTMENTS DENOMINATED IN FOREIGN CURRENCY
   OTHER THAN INVESTMENTS HELD IN SUPPORT OF INSURANCE BUSINESS DENOMINATED IN THE SAME FOREIGN CURRENCY

   Investments denominated in foreign currencies other than investments held in support of insurance business denominated in the same foreign currency, should be accounted for at their
U.S. dollar equivalent values. Income recognized during an accounting period should be recorded at its weighted average U.S. dollar equivalent value, and balance sheet data should be recorded at its U.S. dollar equivalent value as of the balance sheet date.

Changes in balance sheet investment value due to foreign currency translation should be recorded as unrealized capital gains and losses on such investment until the investment is repaid or sold. Upon sale or repayment previously recorded unrealized capital gains and losses should be reversed and the foreign exchange profit or loss for the entire holding period should be recorded as a realized capital gain or loss.

Transactions involving settlement in cash, such as purchases, sales, and receipt of income, should be recorded at their U.S. dollar equivalent value based on the foreign currency exchange rate as of the transaction date. Any foreign currency exchange gains or losses on purchases, sales, maturities or changes in income accruals should be recorded as capital gain or loss realized on the purchase, sale or maturity or as adjustments to income respectively.

Nominal information such as par value may be expressed in the foreign currency or U.S. dollar equivalent (description of issue), but where the information is displayed comparatively (column of par values), U.S. dollar equivalent amounts should be used. Ratios and factors should be based on data that is entirely consistent with respect to currency.

Attachment B

ACCOUNTING FOR INVESTMENTS DENOMINATED IN FOREIGN CURRENCY HELD IN SUPPORT OF INSURANCE BUSINESS DENOMINATED IN THE SAME FOREIGN CURRENCY

Some insurers engage in operations in foreign countries with the premiums collected and claims paid in local currency. As in any insurance operation there will at times be uncollected premiums policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the insurer's balance sheet in the annual statement. For ease in maintaining policy records, the premiums reserves, and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the company receives notification of the claim. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars.

Canadian operations, comprising less than 10% of the insurance company's assets or liabilities can be translated to U.S. dollars by making an adjustment to the net assets of the foreign operation. The adjustment is calculated by summarizing the assets and liabilities in the foreign currency and in U.S. dollars. The net value is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the company. Any difference in the net value to current exchange rates is recorded as a separate asset or liability and the change in the foreign exchange adjustment is recorded as an unrealized capital gain or loss.

All other foreign operations must be translated to U.S. dollars in accordance with the provisions of Financial Accounting Standards Board Statement of Financial Accounting Standard (FAS) No. 52, Foreign Currency Translation. FAS 52 requires each financial statement line to be translated to U.S. dollars by applying the following exchange rates: 1) the current exchange rate at the balance sheet date to assets and liabilities and 2) a weighted average rate to revenue, expenses, gains, losses and surplus adjustments. The weighted-average rate is aimed at approximating the translation that would have been achieved had the current rate at the time of each translation been applied. Gains or losses due to translating foreign operations to U.S. dollars should be recorded as an unrealized capital gain or loss.

Source for language of Attachment B: Foreign Exchange Adjustment. Chapter 8, Phase II of Life and Health Accounting Manual Codification Project
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 13 and 25
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 8
- Purposes and Procedures Manual of the NAIC Securities Valuation Office, Section 1

Generally Accepted Accounting Principles
- FASB Statement No. 52, Foreign Currency Translation
- FASB Emerging Issues Task Force No. 87-12, Foreign Debt-for-Equity Swaps
- FASB Emerging Issues Task Force No. 87-26, Hedging of Foreign Currency Exposure with a Tandem Currency
- FASB Emerging Issues Task Force No. 92-4, Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary
- FASB Emerging Issues Task Force No. 95-2, Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party
- FASB Emerging Issues Task Force No. 96-15, Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities
- FASB Interpretation No. 37, Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity, an interpretation of FASB Statement No. 52
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 12

State Regulations
None

Other Sources of Information
- The Invested Assets Working Group of the Valuation of Securities (EX4) Task Force draft guidance to the Blanks Task Force
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 8
Statutory Issue Paper No. 82

Stock Options and Stock Purchase Plans

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance provides for disclosures concerning deferred compensation plans such as profit sharing, stock options or incentive plans in the NAIC Annual Statement Instructions. However, specific guidance regarding the accounting for such plans is not currently provided.

2. GAAP addresses the accounting for stock issued to employees in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins (ARB 43), Accounting Interpretation of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (AIN-APB 25), FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (FIN 28), FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock (FIN 38) and FASB Statement No. 123, Accounting for Stock-Based Compensation (FAS 123).

3. This purpose of this issue paper is to establish statutory accounting principles for employee stock options and stock purchase plans that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. A plan is any arrangement to issue stock to officers and employees, as a group or individually. Stock purchase and stock option plans shall be classified as either compensatory or noncompensatory. A reporting entity recognizes no compensation expense for services received in return for stock issued through noncompensatory plans. Stock purchase and stock option plans which do not meet the criteria of a noncompensatory plan shall be classified as compensatory. A reporting entity recognizes compensation cost for stock issued through compensatory plans.

Noncompensatory Plans

5. The following four characteristics are essential in a noncompensatory plan:

a. substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded);

b. stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit the number of shares of stock that an employee may purchase through the plan);

c. the time permitted for exercise of an option or purchase right is limited to a reasonable period; and

d. the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others.
Compensatory Plans

6. Consideration that a reporting entity receives for stock issued through employee stock option, purchase, and award plans in the form of services shall be measured by the fair value of the stock at the measurement date less the amount, if any, that the employee is required to pay.

7. The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after the date of grant or award. Thus, a reporting entity recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price of the stock at the measurement date.

8. Compensation cost in stock option, purchase, and award plans shall be recognized as an expense of one or more periods in which an employee performs services and also as part or all of the consideration received for stock issued to the employee through a plan. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the past pattern of grants or awards. An employee may perform services in several periods before a reporting entity issues stock for those services. The reporting entity shall accrue compensation expense in each period in which the services are performed. If the measurement date is later than the date of grant or award, a reporting entity shall record the compensation expense each period from date of grant or award to date of measurement based on the fair value of the stock at the end of each period.

9. Quoted market prices in active markets are the best evidence of fair value and are to be used as fair value, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances.

10. If stock is issued in a plan before some or all of the services are performed, part of the consideration recorded for the stock issued is unearned compensation and shall be reported as a component of unassigned funds. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

Accounting for Income Tax Benefits

11. A reporting entity may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. Generally, the reporting entity is entitled to a deduction for income tax purposes of the amount that an employee reports as ordinary income, and the deduction is allowable to the corporation in the year in which the amount is includable in the gross income of the employee. Thus, the amount and timing of the deduction for income tax purposes, if any, may differ from the related compensation expense recognized in the financial statements. For example, the reporting entity may be entitled to a deduction for income tax purposes even though no compensation expense is recognized in measuring net income.

12. The income tax reduction, if any, related to a stock option, purchase, or award plan shall be accounted for within one or more of the following three components:

   a. Income tax expense for a period shall be reduced by no more than the income tax reduction related to the stock option, purchase, or award plan that is proportionate to compensation expense recognized during the period, for such plan.

   b. Compensation expense that is deductible in the income tax return for a period different from the one in which such expense is reported in measuring net income results in a temporary difference. Deferred income taxes shall be recognized for such differences and
Stock Options and Stock Purchase Plans

included with all deferred income taxes as a separate component of gains and losses in surplus consistent with Issue Paper No. 83—Accounting for Income Taxes.

c. The remainder of the income tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the income tax reduction shall not be included in income, but shall be added to capital stock or gross paid-in and contributed surplus in the period of the income tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the reporting entity may deduct the difference from capital stock or gross paid-in and contributed surplus in the period of the income tax reduction, to the extent that income tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in capital stock or gross paid-in and contributed surplus.

13. In certain situations, it may be advantageous to the reporting entity to compensate an employee to make an option that is detrimental to him but advantageous to the company. A reporting entity may, either by cash payment or otherwise reimburse an employee for his action related to a stock option, purchase, or award plan that results in a reduction of income taxes of the reporting entity; for example, in incentive stock purchase plans a reduction in the purchase price of stock is allowed. The reporting entity shall include any such reimbursement as an expense.

14. Stock option, purchase, and award plans of the principal stockholder (i.e., a holding company) or equity instruments granted or otherwise transferred directly to an employee by a principal stockholder shall be treated as contributed surplus by the principal stockholder with the offsetting charge accounted for in accordance with this issue paper, unless such transfers are clearly for a purpose other than compensation for services rendered the reporting entity.

15. Compensation expense related to stock appreciation rights and other variable stock option or award plans shall be measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

Disclosure

16. The notes to financial statements shall disclose deferred stock compensation plans for employees such as profit sharing, stock options or incentive plans. If warranted by materiality, the following information with regard to stock options shall be furnished and analogous information shall be supplied for warrants or rights:

a. A brief description of the terms of each option arrangement including the title and amount of securities to option; the year or years during which the options were granted; and the year or years during which the optonerees became, or will become, entitled to exercise the options;

b. The number of shares under option at the end of the statement year; the number of shares with respect to which options became exercisable during the year; and the number of shares with respect to which options were exercised during the year; and the option price and fair market value thereof, per share, and in total for each of the three categories;

c. The required information may be summarized as appropriate with respect to each of these categories. The above information shall be supplied whether the stock involved relates to the company, the parent of the company, a subsidiary of the company, or an affiliated
corporation. The information shall be shown separately for (1) agents and brokers and (2) employees and others.

**DISCUSSION**

17. Current statutory guidance provides for disclosures concerning deferred compensation plans such as profit sharing, stock options or incentive plans in the Annual Statement Instructions. This issue paper is consistent with such guidance. This issue paper expands current statutory guidance to provide specific guidance regarding the accounting for such plans. Issue Paper No. 78—Employee Stock Ownership Plans (Issue Paper No. 78) addresses the accounting for Employee Stock Ownership Plans by the plan sponsor.

18. This issue paper rejects FAS 123. FAS 123 encourages, but does not require, that companies report stock based compensation plans using a fair value method of accounting versus the intrinsic value method of accounting promulgated in APB 25. The differences between these two methods of accounting primarily affect the accounting related to stock option plans. Under the intrinsic value method of accounting, the compensation cost of such plans is measured by the excess, if any, of the market price of the underlying stock versus the exercise price of the option at the measurement date. The fair value method of accounting requires that a fair value be determined for the options, generally by utilization of option-pricing models or other valuation techniques, and that the fair value be charged to compensation cost with a corresponding credit to paid in capital. The fair value method of accounting for these plans is rejected because it does not reflect a change in statutory assets or liabilities. Consistent with rejection of FAS 123, the disclosure requirements in the conclusion above retain the current statutory requirements.

19. This issue paper adopts GAAP guidance set forth in APB 25 except for paragraph 19 regarding disclosure. The disclosure required by this issue paper is consistent with the disclosure requirements of ARB 43, Chapter 13B, prior to its amendment by FAS 123. This issue paper adopts GAAP guidance set forth in ARB 43 with modification to exclude the additions to paragraph 2 and the deletion of paragraph 15 pursuant to FAS 123. This issue paper also adopts the GAAP guidance set forth in AIN-APB 25. This issue paper also adopts the GAAP guidance set forth in FIN 28 and FIN 38.

20. Additionally, this issue paper adopts the following pronouncements which clarify and/or provide guidance in certain circumstances (such pronouncements are not reproduced herein due to length and limited scope):

- FASB Emerging Issues Task Force Issue No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout
- FASB Emerging Issues Task Force Issue No. 84-18, Stock Option Pyramiding
- FASB Emerging Issues Task Force Issue No. 85-45, Business Combinations: Settlement of Stock Options and Awards
- FASB Emerging Issues Task Force Issue No. 87-6, Adjustments Relating to Stock Compensation Plans
- FASB Emerging Issues Task Force Issue No. 87-23, Book Value Stock Purchase Plans
- FASB Emerging Issues Task Force Issue No. 87-33, Stock Compensation Issues Related to Market Decline
- FASB Emerging Issues Task Force Issue No. 88-6, Book Value Plans in an Initial Public Offering
- FASB Emerging Issues Task Force Issue No. 90-7, Accounting for a Reload Stock Option
- FASB Emerging Issues Task Force Issue No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring
- FASB Emerging Issues Task Force Issue No. 94-6, Accounting for the Buyout of Compensatory Stock Options
- FASB Emerging Issues Task Force Issue No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25
This issue paper rejects the following pronouncements:

FASB Emerging Issues Task Force Issue No. 96-3, Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123
FASB Emerging Issues Task Force Issue No. 96-18, Accounting for Equity Instruments with Variable Terms That Are Issue For Consideration Other Than Employee Services Under FASB Statement No. 123

21. The conclusions above are consistent with the consistency and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

Consistency

The regulators’ need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Recognition

The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise’s ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

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

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

Drafting Notes/Comments

- Issue Paper No. 78—Employee Stock Ownership Plans addresses the accounting for Employee Stock Ownership Plans by the plan sponsor.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The Life Annual Statement Instructions provide the following guidance (only the pertinent excerpts are included below):

6. Retirement Plans, Deferred Compensation and Other Postretirement Benefit Plans
   b. Deferred Compensation Plans
      1. Indicate if the company has deferred compensation plans for officers or employees such as profit sharing, stock options or incentive plans.
      2. If warranted by materiality, the following information with regard to stock options should be furnished and analogous information should be supplied for warrants or rights:
         a. A brief description of the terms of each option arrangement including the title and amount of securities to option; the year or years during which the options were granted; and the year or years during which the optionees became, or will become, entitled to exercise the options.
         b. The number of shares under option at the end of the statement year; the number of shares with respect to which options became exercisable during the year; and the number of shares with respect to which options were exercised during the year; and the option price and fair market value thereof, per share, and in total for each of the three categories.

Options to buy stock are deemed to be granted on the date that a designated number of shares are assigned to a specific individual, notwithstanding the stipulation at that time that such options are not exercisable until certain attached conditions are met, such as those relating to persistency of insurance produced by the optionee or his continuance in employment for a period of years.

The required information may be summarized as appropriate with respect to each of these categories. The above information should be supplied whether the stock involved relates to the company, the parent of the company, a subsidiary of the company, or an affiliated corporation. The information should be shown separately for (1) agents and brokers and (2) employees and others.

The Property and Casualty Annual Statement Instructions contain similar guidance.

Generally Accepted Accounting Principles

23. ARB 43 provides the following guidance (only the pertinent excerpts are included below):

Chapter 13: COMPENSATION:

Section B -- Compensation Involved in Stock Option and Stock Purchase Plans

1. The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a
measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the corporation's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given herein to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.\footnote{Bulletin 37, “Accounting for Compensation in the Form of Stock Options,” was issued in November, 1948. Issuance of a revised bulletin in 1953 and its expansion to include stock purchase plans were prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A is to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts.}

2. For convenience, this section will discuss primarily the problems of compensation raised by stock option plans. However, the committee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also. FASB Statement No. 123, Accounting for Stock-Based Compensation, specifies a fair value based method of accounting for stock-based compensation plans and encourages entities to adopt that method for all arrangements under which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of the employer's stock. However, Statement 123 permits an employer in determining its net income to continue to apply the accounting provisions of this section and Opinion 25 to all its stock-based employee compensation arrangements. Entities that continue to apply this section and Opinion 25 shall comply with the disclosure requirements of Statement 123.

Rights Involving Compensation

3. Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.

Rights Not Involving Compensation

4. Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.
5. Stock purchase plans also are frequently an integral part of a corporation's program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of compensation need be considered to be present if the purchase price is not lower than is reasonably required to interest employees generally or to secure the contemplated funds.

Other Considerations

14. Upon exercise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.

15. In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

24. APB 25, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

1. Many corporations have adopted various plans, contracts, and agreements to compensate officers and other employees by issuing to them stock of the employer corporation. Under traditional stock option and stock purchase plans an employer corporation grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period or grants rights to purchase shares of stock of the corporation at a stated price, often at a discount from the market price of the stock at the date the rights are granted. Stock options and purchase rights are normally granted for future services of employees. Accounting Research Bulletin No. 43, Chapter 13B, Compensation Involved in Stock Option and Stock Purchase Plans (1953), contains the principles of accounting for those plans (reproduced in Appendix B).

2. Among traditional plans not described in Chapter 13B of ARB No. 43 are plans in which an employer corporation awards to employees shares of stock of the corporation for current or future services. Some corporations have replaced or supplemented traditional plans with more complex plans, contracts, and agreements for issuing stock. An arrangement may be based on variable factors that depend on future events; for example, a corporation may award a variable number of shares of stock or may grant a stock option with a variable option price. Other arrangements combine the characteristics of two or more types of plans, and some give an employee an election.

3. Accounting for employee services received as consideration for stock issued is included in an accounting research study on stockholders' equity that is in process.

4. This Opinion deals with some aspects of accounting for stock issued to employees through both noncompensatory and compensatory plans (a plan is any arrangement to issue stock to officers and employees, as a group or individually). ARB No. 43, Chapter 13B remains in effect for traditional stock option and stock purchase plans except that the measure of compensation is redefined in this Opinion. This Opinion recognizes certain practices that evolved after Chapter 13B of ARB No. 43 was adopted and applies the principles of that chapter to other plans in which the number of shares of stock that may be acquired by or awarded to an employee and the option or purchase price, if any, are known or determinable at the date of grant or award. It also specifies the accounting for (a) plans in which either the number of shares of stock or the option or purchase price depends on future events and (b) income tax benefits related to stock
issued to employees through stock option, purchase, and award plans. Appendix A to the Opinion illustrates measuring and accounting for compensation under typical plans.

Differing Views

5. Some accountants believe that compensation cost for all compensatory plans should be recorded at the date of grant or not later than the date of exercise. They believe that past experience and outside evidence of values can overcome difficulties in measuring compensation. Other accountants believe that compensation need not be recorded if an employee pays an amount that is at least equal to the market price of the stock at the date of grant and that problems in accounting for compensation plans pertain to plans in which the number of shares of stock or the option or purchase price cannot be determined until after the date of grant or award. Still other accountants, although they agree in principle with the first group, believe that progress will result from specifying the accounting for plans with variable factors but leaving Chapter 13B of ARB No. 43 in effect with modifications while the entire topic of accounting for compensation involving stock is studied.

6. Some accountants believe that a tax benefit attributable to compensation that is deductible in computing taxable income but is not recorded as an expense of any period results from a permanent difference. The benefit should therefore be recorded under paragraphs 33 and 34 of APB Opinion No 11, Accounting for Income Taxes, as a reduction of income tax expense for the period that the benefit is received. Other accountants believe that the tax benefit results from issuing stock and should be accounted for as an adjustment of capital in addition to par or stated value of capital stock in accordance with paragraph 52 of APB Opinion No. 11.

OPINION

Noncompensatory Plans

7. Paragraphs 4 and 5 of Chapter 13B of ARB No. 43 describe stock option and stock purchase plans that may not be intended primarily to compensate employees. An employer corporation recognizes no compensation for services in computing consideration received for stock that is issued through noncompensatory plans. The Board concludes that at least four characteristics are essential in a noncompensatory plan: (a) substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded), (b) stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit the number of shares of stock that an employee may purchase through the plan), (c) the time permitted for exercise of an option or purchase right is limited to a reasonable period, and (d) the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others. An example of a noncompensatory plan is the “statutory” employee stock purchase plan that qualifies under Section 423 of the Internal Revenue Code.

Compensatory Plans

8. Plans that do not possess the four characteristics of noncompensatory plans are classified as compensatory plans. Since the major principles of Chapter 13B of ARB No. 43 are not changed, classification as a compensatory plan does not necessarily require that compensation cost be recognized.²

² All compensation arrangements involving stock, regardless of the name given, should be accounted for according to their substance. For example, an arrangement in which the consideration for stock issued to an employee is a nonrecourse note secured by the stock issued may be in substance the same as the grant of a stock option and should be accounted for accordingly. The note should be classified as a reduction of stockholders' equity rather than as an asset.
9. Services as Consideration for Stock Issued. The consideration that a corporation receives for stock issued through a stock option, purchase, or award plan consists of cash or other assets, if any, plus services received from the employee.

10. Measuring Compensation for Services. Compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay. That is the principle in Chapter 13B of ARB No. 43 with two modifications: (a) the meaning of fair value of stock for compensatory plans is narrowed and (b) the measurement date for plans with a variable number of shares of stock or a variable option or purchase price is different.

   a. Quoted market price is substituted for fair value. The Board acknowledges the conclusion in Chapter 13B that "market quotations at a given date are not necessarily conclusive evidence" of fair value of shares of stock but concludes that, for purposes of this Opinion, the unadjusted quoted market price of a share of stock of the same class that trades freely in an established market should be used in measuring compensation. An employee's right to acquire or receive shares of stock is presumed to have a value and that value stems basically from the value of the stock to be received under the right. However, the value of the right is also affected by various other factors, some of which tend to diminish its value and some of which tend to enhance it. Those opposing factors include a known future purchase price (or no payment), restrictions on the employee's right to receive stock, absence of commissions on acquisition, different risks as compared with those of a stockholder, tax consequences to the employee, and restrictions on the employee's ability to transfer stock issued under the right. The effects of the opposing factors are difficult to measure, and a practical solution is to rely on quoted market price to measure compensation cost related to issuing both restricted (or letter) and unrestricted stock through stock option, purchase, or award plans. If a quoted market price is unavailable, the best estimate of the market value of the stock should be used to measure compensation.

   b. The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee and is therefore unchanged from Chapter 13B of ARB No. 43. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after date of grant or award.

Thus a corporation recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price of the stock at the measurement date.

11. Applying the measurement principle--The following supplements paragraph 10 for special situations in some plans.

   a. Measuring compensation by the cost to an employer corporation of reacquired (treasury) stock that is distributed through a stock option, purchase, or award plan is not acceptable practice. The only exception is that compensation cost under a plan with all the provisions described in paragraph 11(c) may be measured by the cost of stock that the corporation (1) reacquires during the fiscal period for which the stock is to be awarded and (2) awards shortly thereafter to employees for services during that period.
b. The measurement date is not changed from the grant or award date to a later date solely by provisions that termination of employment reduces the number of shares of stock that may be issued to an employee.

c. The measurement date of an award of stock for current service may be the end of the fiscal period, which is normally the effective date of the award, instead of the date that the award to an employee is determined if (1) the award is provided for by the terms of an established formal plan, (2) the plan designates the factors that determine the total dollar amount of awards to employees for the period (for example, a percent of income), although the total amount or the individual awards may not be known at the end of the period, and (3) the award pertains to current service of the employee for the period.

d. Renewing a stock option or purchase right or extending its period establishes a new measurement date as if the right were newly granted.

e. Transferring stock or assets to a trustee, agent, or other third party for distribution of stock to employees under the terms of an option, purchase, or award plan does not change the measurement date from a later date to the date of transfer unless the terms of the transfer provide that the stock (1) will not revert to the corporation, (2) will not be granted or awarded later to the same employee on terms different from or for services other than those specified in the original grant or award, and (3) will not be granted or awarded later to another employee.

f. The measurement date for a grant or award of convertible stock or (stock that is otherwise exchangeable for other securities of the corporation) is the date on which the ratio of conversion (or exchange) is known unless other terms are variable at that date (paragraph 10b). The higher of the quoted market price at the measurement date of (1) the convertible stock granted or awarded or (2) the securities into which the original grant or award is convertible should be used to measure compensation.

g. Cash paid to an employee to settle an earlier award of stock or to settle a grant of option to the employee should measure compensation cost. If the cash payment differs from the earlier measure of the award of stock or grant of option, compensation cost should be adjusted (paragraph 15). The amount that a corporation pays to an employee to purchase stock previously issued to the employee through a compensation plan is “cash paid to an employee to settle an earlier award of stock or to settle a grant of option” if stock is reacquired shortly after issuance. Cash proceeds that a corporation receives from sale of awarded stock or stock issued on exercise of an option and remits to the taxing authorities to cover required withholding of income taxes on an award is not “cash paid to an employee to settle an earlier award of stock or to settle a grant of option” in measuring compensation cost.

h. Some plans are a combination of two or more types of plans. An employer corporation may need to measure compensation for the separate parts. Compensation cost for a combination plan permitting an employee to elect one part should be measured according to the terms that an employee is most likely to elect based on the facts available each period.

12. **Accruing Compensation Cost.** Compensation cost in stock option, purchase, and award plans should be recognized as an expense of one or more periods in which an employee performs services and also as part or all of the consideration received for stock issued to the employee through a plan. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the
past pattern of grants or awards (ARB No. 43, Chapter 13B, paragraph 14; APB Opinion No. 12, Omnibus Opinion--1967, paragraph 6).

13. An employee may perform services in several periods before an employer corporation issues stock to him for those services. The employer corporation should accrue compensation expense in each period in which the services are performed. If the measurement date is later than the date of grant or award, an employer corporation should record the compensation expense each period from date of grant or award to date of measurement based on the quoted market price of the stock at the end of each period.

14. If stock is issued in a plan before some or all of the services are performed, part of the consideration recorded for the stock issued is unearned compensation and should be shown as a separate reduction of stockholders' equity. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

3 State law governs the issuance of a corporation's stock including the acceptability of issuing stock for future services.

15. Accruing compensation expense may require estimates, and adjustment of those estimates in later periods may be necessary (APB Opinion No. 20, Accounting Changes, paragraphs 31 to 33. For example, if a stock option is not exercised (or awarded stock is returned to the corporation) because an employee fails to fulfill an obligation, the estimate of compensation expense recorded in previous periods should be adjusted by decreasing compensation expense in the period of forfeiture.

16. Accounting for Income Tax Benefits. An employer corporation may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. A corporation is usually entitled to a deduction for income tax purposes of the amount that an employee reports as ordinary income, and the deduction is allowable to the corporation in the year in which the amount is includable in the gross income of the employee. Thus, a deduction for income tax purposes may differ from the related compensation expense that the corporation recognizes, and the deduction may be allowable in a period that differs from the one in which the corporation recognizes compensation expense in measuring net income.

4 A corporation may be entitled to a deduction for income tax purposes even though it recognizes no compensation expenses in measuring net income.

17. An employer corporation should reduce income tax expense for a period by no more of a tax reduction under a stock option, purchase, or award plan than the proportion of the tax reduction that is related to the compensation expense for the period. Compensation expenses that are deductible in a tax return in a period different from the one in which they are reported as expenses in measuring net income result in temporary differences, and deferred taxes should be recorded in accordance with the provisions of FASB Statement No. 109, Accounting for Income Taxes. The remainder of the tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the tax reduction should not be included in income but should be added to capital in addition to par or stated value of capital stock in the period of the tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the corporation may deduct the difference from additional capital in the period of the tax reduction to the extent that tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in additional capital.
18. A corporation may, either by cash payment or otherwise—for example, by allowing a reduction in the purchase price of stock—reimburse an employee for his action related to a stock option, purchase, or award plan that results in a reduction of income taxes of the corporation. The corporation should include the reimbursement in income as an expense.

19. Disclosure. ARB No. 43 Chapter 13B, specifies in paragraph 15 the disclosures related to stock option and stock purchase plans that should be made in financial statements.\(^5\)

\(^5\) Other disclosure requirements are in Regulation S-X for financial statements filed with the Securities and Exchange Commission and in listing agreements of the stock exchanges for financial statements included in annual reports to stockholders.

25. AIN-APB 25 provides the following guidance (only the pertinent excerpts are included below):

1. STOCK PLANS ESTABLISHED BY A PRINCIPAL STOCKHOLDER

   Question—Accounting for compensatory and noncompensatory stock option, purchase and award plans adopted by a corporation is discussed in APB Opinion No. 25 and ARB No. 43, Chapter 13B. Should a corporation account for plans or transactions (“plans”), if they have characteristics otherwise similar to compensatory plans adopted by corporations, that are established or financed by a principal stockholder (i.e., one who either owns 10% or more of the corporation's common stock or has the ability, directly or indirectly, to control or influence significantly the corporation)?

   Interpretation—It is difficult to evaluate a principal stockholder's intent when he establishes or finances a plan with characteristics otherwise similar to compensatory plans generally adopted by corporations. A principal stockholder may be satisfying his generous nature, settling a moral obligation, or attempting to increase or maintain the value of his own investment. If a principal stockholder’s intention is to enhance or maintain the value of his investment by entering into such an arrangement, the corporation is implicitly benefitting from the plan by retention of, and possibly improved performance by, the employee. In this case, the benefits to a principal stockholder and to the corporation are generally impossible to separate. Similarly, it is virtually impossible to separate a principal stockholder's personal satisfaction from the benefit to the corporation. Accounting Principles Board Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, paragraph 127 states that "Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment."

   The economic substance of this type of plan is substantially the same for the corporation and the employee, whether the plan is adopted by the corporation or a principal stockholder. Consequently, the corporation should account for this type of plan when one is established or financed by a principal stockholder unless (1) the relationship between the stockholder and the corporation's employee is one which would normally result in generosity (i.e., an immediate family relationship), (2) the stockholder has an obligation to the employee which is completely unrelated to the latter's employment (e.g., the stockholder transfers shares to the employee because of personal business relationships in the past, unrelated to the present employment situation), or (3) the corporation clearly does not benefit from the transaction (e.g., the stockholder transfers shares to a minor employee with whom he has had a close relationship over a number of years).

   This type of plan should be treated as a contribution to capital by the principal stockholder with the offsetting charge accounted for in the same manner as compensatory plans adopted by corporations.
Compensation cost should be recognized as an expense of one or more periods in accordance with the provisions of APB Opinion No. 25, paragraphs 12 through 15.

The corporation should account for tax benefits, if any, from this type of plan in accordance with the provisions of APB Opinion No. 25, paragraphs 16 through 18. If the corporation receives no tax benefit from this type of plan, but would have received such benefit had the plan been adopted by the corporation, the absence of such tax benefit is one of the variables in estimating the plan's cost to the corporation (see APB Opinion No. 16, paragraph 89).

26. FIN 28, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

FIN 28 Summary

This Interpretation clarifies aspects of accounting for compensation related to stock appreciation rights and other variable stock option or award plans. The Interpretation specifies that compensation should be measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

INTRODUCTION

1. The FASB has been asked to clarify whether the provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, apply to stock appreciation rights and, if so, how the Opinion should be applied. Similar questions have been raised about awards under other stock compensation plans with variable terms, that is, plans for which the number of shares of stock the employee may receive, the price per share the employee must pay, or both the number of shares and the price are unknown at the date of grant or award. Appendix A provides additional background information about these matters. Appendix B illustrates applications of this Interpretation.

INTERPRETATION

2. APB Opinion No. 25 applies to plans for which the employer's stock is issued as compensation or the amount of cash paid as compensation is determined by reference to the market price of the stock or to changes in its market price. Plans involving stock appreciation rights and other variable plan awards are included in those plans dealt with by Opinion No. 25. When stock appreciation rights or other variable plan awards are granted, an enterprise shall measure compensation as the amount by which the quoted market value of the shares of the enterprise's stock covered by the grant exceeds the option price or value specified, by reference to a market price or otherwise, subject to any appreciation limitations under the plan. Changes, either increases or decreases, in the quoted market value of those shares between the date of grant and the measurement date result in a change in the measure of compensation for the right or award.

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1 Plans for which the number of shares of stock that may be acquired by or awarded to an employee or the price or both are not specified or determinable until after the date of grant or award are referred to in this Interpretation as "variable plan awards." However, plans described in paragraph 11(c) of Opinion No. 25 (see paragraph 12 in Appendix A of this Interpretation) and book value stock option, purchase, or award plans are not covered by this Interpretation. Plans under which an employee may receive cash in lieu of stock or additional cash upon the exercise of a stock option are variable plans for purposes of this Interpretation if the amount is contingent on the occurrence of future events.
Paragraph 10 of Opinion No. 25 defines the measurement date as “the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any.” Generally, the number of shares of stock that may be acquired or awarded under stock appreciation rights and many other variable plan awards are not known until the date that they are exercised.

3. Compensation determined in accordance with paragraph 2 shall be accrued as a charge to expense over the period or periods the employee performs the related services (hereinafter referred to as the “service period”). If the stock appreciation rights or other variable plan awards are granted for past services, compensation shall be accrued as a charge to expense of the period in which the rights or awards are granted. If the service period is not defined in the plan or some other agreement, such as an employment agreement, as a shorter or previous period, the service period shall be presumed to be the vesting period.3

3 For purposes of this Interpretation, stock appreciation rights and other variable plan awards become vested when the employee’s right to receive or retain shares or cash under the rights or awards is not contingent upon the performance of additional services. Frequently, the vesting period is the period from the date of grant to the date the rights or awards become exercisable.

4. Compensation accrued during the service period in accordance with paragraph 3 shall be adjusted in subsequent periods up to the measurement date4 for changes, either increases or decreases, in the quoted market value of the shares of the enterprise’s stock covered by the grant but shall not be adjusted below zero. The offsetting adjustment shall be made to compensation expense of the period in which changes in the market value occur. Except as provided in paragraph 5, the accrued compensation for a right that is forfeited or canceled shall be adjusted by decreasing compensation expense in the period of forfeiture, in accordance with paragraph 15 of APB Opinion No. 25.

4 See footnote 2.

5. For purposes of applying paragraph 11(h)5 of APB Opinion No. 25, compensation expense for a combination plan6 involving stock appreciation rights or other variable plan awards (including those that are granted after the date of grant of related stock options) shall be measured according to the terms the employee is most likely to elect based on the facts available each period. An enterprise shall presume that the employee will elect to exercise the stock appreciation rights or other variable plan awards, but the presumption may be overcome if past experience or the terms of a combination plan that limit the market appreciation available to the employee in the stock appreciation rights or other variable plan awards provide evidence that the employee will elect to exercise the related stock option. If an enterprise has been accruing compensation for a stock appreciation right or other variable plan award and a change in circumstances provides evidence that the employee will likely elect to exercise the related stock option, accrued compensation recorded for the right or award shall not be adjusted.7 If the employee elects to exercise the stock option, the accrued compensation recorded for the right or award shall be recognized as a consideration for the stock issued. If all parts of the grant or award (e.g., both the option and the right or award) are forfeited or canceled, accrued compensation shall be adjusted by decreasing compensation expense in that period.

5 See paragraph 13 in Appendix A of this Interpretation.

6 See paragraph 10 in Appendix A of this Interpretation.
A change in the circumstances may be indicated by market appreciation in excess of any appreciation limitations under the plan or the cancellation or forfeiture of the stock appreciation right or other variable plan award without a concurrent cancellation or forfeiture of the related stock option. A subsequent decrease in market value that reduces the appreciation to a level below the limitations under the plan would require adjustment of accrued compensation in accordance with paragraph 4 of this Interpretation if evidence then indicates that the employee will elect to exercise the stock appreciation right or other variable plan award.

27. FIN 38, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

FIN 38 Summary

APB Opinion No. 25, Accounting for Stock Issued to Employees, specifies that the measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (a) the number of shares that an individual employee is entitled to receive and (b) the option or purchase price, if any. Opinion 25 also specifies that the measurement date for a grant or award of convertible stock is the date on which the ratio of conversion is known unless other terms are variable at that date. Questions have been raised about determining the measurement date for stock option, purchase, and award plans involving junior stock, a separate class of stock issued to certain employees that is subordinate to an employer's regular common stock but is convertible into common stock if specified future events occur. This Interpretation clarifies that the measurement date for grants under stock option, purchase, and award plans involving junior stock is the date on which the number of shares of the employer's regular common stock that an employee is entitled to receive in exchange for the junior stock is known. This Interpretation is effective for grants made to employees on or after March 14, 1984 under stock option, purchase, and award plans involving junior stock.

INTRODUCTION

1. The Board has been asked to clarify certain provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, relating to determining the measurement date for grants made to employees under stock option, purchase, and award plans involving junior stock. As used in this Interpretation, the term junior stock refers to a specific type of stock issued to employees that generally is subordinate to an employer's regular common stock with respect to voting, liquidation, and dividend rights and is convertible into regular common stock if certain performance goals are achieved or if certain transactions occur. Junior stock generally is not transferable, except back to the issuing enterprise, and has a fair value lower than regular common stock because of its subordinate rights and the uncertainty of conversion to regular common stock.

2. Stock option, purchase, and award plans involving junior stock are designed to provide that an employer ultimately will issue shares of regular common stock to employees. Those plans are variable plans because the number of shares of regular common stock that an individual employee is entitled to receive is not known until certain performance goals are achieved or certain transactions occur. Therefore, for purposes of measuring compensation cost under Opinion 25, the measurement date for grants under stock option, purchase, and award plans involving junior stock is the first date on which are known both the number of shares of the employer's regular common stock that an employee is entitled to receive in exchange for the junior stock and the option or purchase price, if any.
2 The term variable plan, as used in this Interpretation, is defined in paragraph 14.

3. In considering the convertible features of junior stock, paragraph 11(f) of Opinion 25 indicates that the measurement date for a grant or award of convertible stock is the date on which the ratio of conversion is known, unless other terms are variable at that date. Because conversion of junior stock to regular common stock generally is contingent on achieving certain performance goals or on certain transactions occurring, the conversion ratio is not known with certainty until those future events occur. After those goals are achieved or those transactions occur, the conversion ratio is determinable and, accordingly, the number of shares of regular common stock that an individual is entitled to receive is known.

3 If junior stock becomes convertible only to an equal number of shares of regular common stock upon achieving certain performance goals, the conversion ratio is either one-to-zero or one-to-one; some junior stock plans provide for different ratios of conversion depending on the level of performance attained.

4. Compensation cost for stock option, purchase, and award plans involving junior stock shall be accrued according to the provisions of paragraphs 2-4 of FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, and paragraph 11(g) of Opinion 25. However, the provisions of paragraph 2 of Interpretation 28 shall be applied only when it becomes probable that certain performance goals will be achieved or certain transactions will occur; that probability may or may not be present at the date junior stock is issued.

4 Probable is used here, consistent with its use in FASB Statement No. 5, Accounting for Contingencies, to mean that it is likely that certain performance goals will be achieved or certain transactions will occur.

5. Stock option, purchase, and award plans involving junior stock generally are based on certain performance goals being achieved or certain transactions occurring within specific periods. Some plans, however, do not specify a period during which those future events must occur. If it is probable that the future event will occur at some time, compensation cost shall be charged to expense over the period from the date the future event becomes probable to the date the future event is most likely to occur or the end of any required service period. Other plans provide for different ratios of conversion of junior stock to regular common stock within a specific period based on variable performance goals. If achieving more than one performance goal is probable, compensation cost shall be based on the highest ratio of conversion of junior stock to regular common stock attributable to those goals whose achievement is probable. However, the final measure of compensation cost shall be based on the ratio of conversion attributable to the performance goal achieved at the measurement date. For all plans, total compensation shall be based on the market price of the regular common stock as of the date compensation cost is determined.

5 The term service period, as used in this Interpretation, is defined in paragraph 16.

6. Total compensation cost shall be the amount by which the market price at the measurement date of the employer's regular common stock that an employee is entitled to receive exceeds the amount that the employee paid or will pay for the junior stock. If vesting provisions cause junior stock to become convertible to regular common stock after the measurement date, compensation cost shall be recognized during the period from (a) the first...
date that it becomes probable that the future events will occur or the date the events have occurred to (b) the date that junior stock becomes convertible or the end of the service period, whichever occurs first. If junior stock does not become convertible to regular common stock but cash is paid to an employee to purchase previously issued junior stock, total compensation cost is the amount by which cash paid to the employee exceeds the amount initially paid by the employee for the junior stock.

28. FAS 123 provides the following guidance (only the pertinent excerpts are included below):

INTRODUCTION

1. This Statement establishes a fair value based method of accounting for stock-based compensation plans. It encourages entities to adopt that method in place of the provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, for all arrangements under which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of its stock.

2. This Statement also establishes fair value as the measurement basis for transactions in which an entity acquires goods or services from nonemployees in exchange for equity instruments. This Statement uses the term compensation in its broadest sense to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee or not. For example, employee compensation includes both cash salaries or wages and other consideration that may be thought of more as means of attracting, retaining and motivating employees than as direct payment for services rendered.

3. Opinion 25, issued in 1972, requires compensation cost for stock-based employee compensation plans to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. Opinion 25 specifies different dates for the pertinent quoted market price of the stock used in measuring compensation cost, depending on whether the terms of an award are fixed or variable, as those terms are defined in Opinion 25.

4. Since 1972, stock options and other forms of stock-based employee compensation plans have become increasingly common. Also, option-pricing models have become widely used for measuring the value of stock options and similar equity instruments other than those issued to employees as compensation. Opinion 25 has been criticized for producing anomalous results and for providing little general guidance to use in deciding how to account for new forms of stock-based employee compensation plans. Several FASB Interpretations and Technical Bulletins have dealt with specific kinds of plans, and the Emerging Issues Task Force has considered numerous related issues.

5. Because of the perceived deficiencies in Opinion 25, early in the 1980s the AICPA’s Accounting Standards Executive Committee, the staff of the Securities and Exchange Commission, most of the larger accounting firms, industry representatives and others asked the Board to reconsider the accounting specified in Opinion 25. This Statement, which is the result of
that reconsideration, establishes an accounting method based on the fair value of equity instruments awarded to employees as compensation that mitigates many of the deficiencies in Opinion 25. The Board encourages entities to adopt the new method. However, this Statement permits an entity in determining its net income to continue to apply the accounting provisions of Opinion 25 to its stock-based employee compensation arrangements. An entity that continues to apply Opinion 25 must comply with the disclosure requirements of this Statement, which supersedes the disclosure requirements of paragraph 19 of Opinion 25. This Statement also supersedes or amends other accounting pronouncements listed in Appendix D. Appendix A explains the reasons the Board decided not to require recognition of compensation cost for stock-based employee compensation arrangements measured in accordance with the fair value based method described in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope and Alternative Accounting Methods

6. This Statement applies to all transactions in which an entity acquires goods or services by issuing equity instruments or by incurring liabilities to the supplier in amounts based on the price of the entity’s common stock or other equity instruments. Therefore, it applies to all transactions in which an entity grants shares of its common stock, stock options, or other equity instruments to its employees, except for equity instruments held by an employee stock ownership plan.5

7. The accounting for all stock-based compensation arrangements with employees or others shall reflect the inherent rights and obligations, regardless of how those arrangements are described. For example, the rights and obligations embodied in a transfer to stock to an employee for consideration of a nonrecourse note are substantially the same as if the transaction were structured as the grant of a stock option, and the transaction shall be accounted for as such. The terms of the arrangement may affect the fair value of the stock options or other equity instruments and shall be appropriately reflected in determining that value. For example, whether an employee who is granted an implicit option structured as the exchange of shares of stock for a nonrecourse note is required to pay nonrefundable interest on the note affects the fair value of the implicit option.

Accounting for Transactions with Other Than Employees

8. Except for transactions with employees that are within the scope of Opinion 25, all transactions in which goods or services are the consideration received for the issuance of equity instruments shall be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The fair value of goods or services received from suppliers other than employees frequently is reliably measurable and therefore indicates the fair value of the equity instruments issued. The fair value of the equity instruments issued shall be used to measure the transaction if that value is more reliably measurable than the fair value of the consideration received.6 A common example of the latter situation is the use of the fair value of tradable equity instruments issued in a purchase.
business combination to measure the transaction because the value of the equity instruments issued is more reliably measurable than the value of the business acquired.

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6 The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include intangible rights. FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Insured in Defending Against a Takeover Attempt, provides pertinent guidance.

9. This Statement uses the term *fair value* for assets and financial instruments, including both liability and equity instruments, with the same meaning as in FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Live Assets to be Disposed Of, Statement 121 says that the fair value of an asset is

...the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis [paragraph 7].

10. If the fair value of the goods or services received is not reliably measurable, paragraph 8 of this Statement requires that the measure of the cost of goods or services acquired in a transaction with other than an employee is based on the fair value of the equity instruments issued. However, this Statement does not prescribe the *measurement date*, that is, the date of the stock price on which the fair value of the equity instrument is based, for a transaction with a nonemployee (paragraphs 70-73).

Accounting for Transactions with Employees

11. This Statement provides a choice of accounting methods for transactions with employees that are within the scope of Opinion 25. Paragraphs 16-44 of this Statement describe a method of accounting based on the fair value, rather than the *intrinsic value*, of an employee stock option or a similar equity instrument. The Board encourages entities to adopt the fair value based method of accounting, which is preferable to the Opinion 25 method for purposes of justifying a change in accounting principle under APB Opinion No. 20, Accounting Changes.7 However, an entity may continue to apply Opinion 25 in accounting for its stock-based employee compensation arrangements. An entity that does so shall disclose pro forma net income and, if presented, earnings per share, determined as if the fair value based method had been applied in measuring compensation cost (paragraph 45).

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7 Opinion 20, paragraph 8, provides that initial adoption of an accounting principle for a transaction that the entity has not previously had to account for is not a change in accounting principle.

12. The fair value based method described in paragraphs 16-44 of this Statement applies for (a) measuring stock-based employee compensation cost by an entity that adopts that method for accounting purposes and (b) determining the pro forma disclosures required of an entity that measures stock-based employee compensation cost in accordance with the intrinsic value based method in Opinion 25. Neither those paragraphs (16-44) nor subsequent paragraphs (45-54) of this Statement affect application of the *accounting provisions* of Opinion 25 by an entity that continues to apply it in determining reported net income.
13. For convenience, in describing the fair value based method, paragraphs 16-44 of this Statement refer only to recognition or accounting requirements. However, those provisions apply equally in determining the pro forma amounts that must be disclosed if an entity continues to apply Opinion 25.

14. An entity shall apply the same accounting method—either the fair value based method described in this Statement or the intrinsic value based method in Opinion 25—in accounting for all of its stock-based employee compensation arrangements. Once an entity adopts the fair value based method for those arrangements, that election shall not be reversed.  

15. Equity instruments granted or otherwise transferred directly to an employee by a principal stockholder are stock-based employee compensation to be accounted for by the entity under either Opinion 25 or this Statement, whichever method the entity is applying, unless the transfer clearly is for a purpose other than compensation. The substance of a transaction in which a principal stockholder directly transfers equity instruments to an employee as compensation is that the principal stockholder makes a capital contribution to the entity and the entity awards equity instruments to its employee. An example of a situation in which a direct transfer of equity instruments to an employee from a principal stockholder is not compensation cost is a transfer to settle an obligation of the principal stockholder unrelated to employment by the reporting entity.

VALUATION OF EQUITY INSTRUMENTS ISSUED FOR EMPLOYEE SERVICES

Measurement Basis

16. Frequently, part or all of the consideration received for equity instruments issued to employees is past or future employee services. Equity instruments issued to employees and the cost of the services received as consideration shall be measured and recognized based on the fair value of the equity instruments issued. The portion of the fair value of an equity instrument attributed to employee services is net of the amount, if any, that employees pay for the instrument when it is granted. Paragraphs 17-25 of this Statement provide guidance on how to measure the fair value of stock-based employee compensation. Paragraphs 26-33 provide guidance on how to attribute compensation cost to the periods in which employees render the related services. Appendix B, which is an integral part of this Statement, provides additional guidance on both measurement and attribution of employee compensation cost.

Measurement Objective and Date

17. The objective of the measurement process is to estimate the fair value, based on the stock price at the grant date, of stock options or other equity instruments to which employees become entitled when they have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise stock options or to sell shares of stock). Restrictions that continue in effect after employees have earned the rights to benefit from their instruments, such as the inability to transfer vested employee stock options to third parties, affect the value of the instruments actually issued and therefore are reflected in estimating their fair value. However, restrictions that stem directly from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested option or to sell nonvested stock, do not affect the value of the instruments issued at the vesting date, and their effect therefore is not included in that value.
Instead, no value is attributed to instruments that employees forfeit because they fail to satisfy specified service- or performance-related conditions.

Measurement Methods

Awards That Call for Settlement by Issuing Equity Instruments

18. The fair value of a share of nonvested stock awarded to an employee shall be measured at the market price (or estimated market price, if the stock is not publicly traded) of a share of the same stock as if it were vested and issued on the grant date. Nonvested stock granted to employees usually is referred to as restricted stock, but this Statement reserves that term for shares whose sale is contractually or governmentally restricted after the shares are vested and fully outstanding. The fair value of a share of restricted stock awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount as a share of similarly restricted stock issued to nonemployees.

19. The fair value of a stock option (or its equivalent) granted by a public entity shall be estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current price of the underlying stock and its expected volatility, expected dividends on the stock (except as provided in paragraphs 32 and 33), and the risk-free interest rate for the expected term of the option. For options that a U.S. entity grants on its own stock, the risk-free interest rate used shall be the rate currently available on zero-coupon U.S. government issues with a remaining term equal to the expected life of the options. Guidance on selecting other assumptions is provided in Appendix B. The fair value of an option estimated at the grant date shall not be subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock or the risk-free interest rate.

20. A nonpublic entity shall estimate the value of its options based on the factors described in the preceding paragraph, except that a nonpublic entity need not consider the expected volatility of its stock over the expected life of the option. The result of excluding volatility in estimating an option’s value is an amount commonly termed minimum value.

21. It should be possible to reasonably estimate the fair value of most stock options and other equity instruments at the date they are granted. Appendix B illustrates techniques for estimating the fair values of several options with complicated features. However, in unusual circumstances, the terms of a stock option or other equity instrument may make it virtually impossible to reasonably estimate the instrument's fair value at the date it is granted. For example, it may be extremely difficult, if not impossible, to reasonably estimate the fair value of a stock option whose exercise price decreases (or increases) by a specified amount with specified changes in the price of the underlying stock. Similarly, it may not be possible to reasonably estimate the value of a convertible instrument if the conversion ratio depends on the outcome of future events.

22. If it is not possible to reasonably estimate the fair value of an option or other equity instrument at the grant date, the final measure of compensation cost shall be the fair value based on the stock price and other pertinent factors at the first date at which it is possible to reasonably estimate that value. Generally, that is likely to be the date at which the number of shares to which an employee is entitled and the exercise price are determinable. Estimates of compensation cost for periods during which it is not possible to determine fair value shall be based on the current intrinsic value of the award, determined in accordance with the terms that would apply if the option or similar instrument had been currently exercised.

23. If an employee stock purchase plan satisfies all of the following criteria, the plan is not compensatory. Therefore, the discount from market price merely reduces the proceeds from issuing the related shares of stock.
a) The plan incorporates no option features other than the following, which may be incorporated:

(1) Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

(2) The purchase price is based solely on the stock’s market price at date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

b) The discount from the market price does not exceed the greater of (1) a per-share discount that would be reasonable in a recurring offer of stock to stockholders or others or (2) the per-share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering. A discount of 5 percent or less from the market price shall be considered to comply with this criterion without further justification.

c) Substantially all full-time employees that meet limited employment qualifications may participate on an equitable basis.

24. A plan provision that establishes the purchase price as an amount based on the lesser of the stock’s market price at date of grant or its market price at date of purchase is, for example, an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the stock’s market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan.

Awards That Call for Settlement in Cash

25. Some awards of stock-based compensation result in the entity’s incurring a liability because employees can compel the entity to settle the award by transferring its cash or other assets to employees rather than by issuing equity instruments. For example, an entity may incur a liability to pay an employee either on demand or at a specified date an amount to be determined by the increase in the entity’s stock price from a specified level. The amount of the liability for such an award shall be measured each period based on the current stock price. The effects of change in the stock price during the service period are recognized as compensation cost over the service period in accordance with the method illustrated in FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. Changes in the amount of the liability due to stock price changes after the service period are compensation cost of the period in which the changes occur.

Recognition of Compensation Cost

26. The total amount of compensation cost recognized for an award of stock-based employee compensation shall be based on the number of instruments that eventually vest. No compensation cost is recognized for awards that employees forfeit either because they fail to satisfy a service requirement for vesting, such as for a fixed award, or because the entity does not achieve a performance condition, unless the condition is a target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned. For awards with the latter condition, compensation cost shall be recognized for awards to employees who remain in service for the requisite period regardless of whether the target stock price or amount of intrinsic value is reached. Previously recognized compensation cost shall not be reversed if a vested employee stock option expires unexercised.
The existence of a target stock price that must be achieved to make an option exercisable generally affects the value of the option. Option-pricing models have been adapted to value many of those path-dependent options.

27. For purposes of this Statement, a stock-based employee compensation award becomes vested when an employee’s right to receive or retain shares of stock or cash under the award is not contingent on the performance of additional services. Typically, an employee stock option that is vested also is immediately exercisable. However, if performance conditions affect either the exercise price or the exercisability date, the service period used for attribution purposes shall be consistent with the assumptions used in estimating the fair value of the award. Paragraphs 209 and 310 in Appendix B illustrate how to account for an option whose exercise price depends on a performance condition.

28. An entity may choose at the grant date to base accruals of compensation cost on the best available estimate of the number of options or other equity instruments that are expected to vest and to revise that estimate, if necessary, if subsequent information indicates that actual forfeitures are likely to differ from initial estimates. Alternatively an entity may begin accruing compensation cost as if all instruments granted that are subject only to a service requirement are expected to vest. The effect of actual forfeitures would then be recognized as they occur. Initial accruals of compensation cost for an award with a performance condition that will determine the number of options or shares to which all employees receiving the award will be entitled shall be based on the best estimate of the outcome of the performance condition, although forfeitures by individual employees may either be estimated at the grant date or recognized only as they occur.11

11 For convenience, the remainder of this document refers to options or shares expected to vest because referring specifically to both acceptable methods of accounting for forfeitures by individual employees each time the point is mentioned would be too unwieldy.

29. Compensation cost estimated at the grant date for the number of instruments that are expected to vest based on performance-related conditions, as well as those in which vesting is contingent only on future service for which the entity chooses to estimate forfeitures at the grant date pursuant to paragraph 28, shall be adjusted for subsequent changes in the expected or actual outcome of service- and performance-related conditions until the vesting date. The effect of a change in the estimated number of shares or options expected to vest is a change in an estimate, and the cumulative effect of the change on current and prior periods shall be recognized in the period of the change.

30. The compensation cost for an award of equity instruments to employees shall be recognized over the period(s) in which the related employee services are rendered by a charge to compensation cost and a corresponding credit to equity (paid-in capital) if the award is for future service. If the service period is not defined as an earlier or shorter period, the service period shall be presumed to be the period from the grant date to the date that the award is vested and its exercisability does not depend on continued employee service (paragraph 27). If an award is for past services, the related compensation cost shall be recognized in the period in which it is granted.

31. Compensation cost for an award with a graded vesting schedule shall be recognized in accordance with the method described in Interpretation 28 if the fair value of the award is determined based on different expected lives for the options that vest each year, as it would be if the award is viewed as several separate awards, each with a different vesting date. If the expected life or lives of the award is determined in another manner, the related compensation cost may be recognized on a straight-line basis. However, the amount of compensation cost
recognized at any date must at least equal the value of the vested portion of the award at that
date. Appendix B illustrates application of both attribution methods to an award accounted for by
the fair value based method.

32. Dividends or dividend equivalents paid to employees on the portion of an award of stock
or other equity instruments that vests shall be charged to retained earnings. Nonforfeitable
dividends or dividend equivalents paid on shares of stock that do not vest shall be recognized as
additional compensation cost. The choice of whether to estimate forfeitures at the grant date or to
recognize the effect of forfeitures as they occur described in paragraph 28 also applies to
recognition of nonforfeitable dividends paid on shares that do not vest.

33. If employees received only the dividends declared on the class of stock granted to them
after the stock becomes vested, that value of the award at the grant date shall be reduced by the
present value of dividends expected to be paid on the stock during the vesting period, discounted
at the appropriate risk-free interest rate. The fair value of an award of stock options on which
dividend equivalents are paid to employees or are applied to reduce the exercise price pursuant
to antidilution provisions shall be estimated based on a dividend payment of zero.

Additional Awards and Modifications of Outstanding Awards

34. The fair value of each award of equity instruments, including an award of reload
options, shall be measured separately based on its terms and the current stock price and related
factors at the date it is granted.

35. A modification of the terms of an award that makes it more valuable shall be treated as
an exchange of the original award for a new award. In substance, the entity repurchases the
original instrument by issuing a new instrument of greater value, incurring additional
compensation cost for that incremental value. The incremental value shall be measured by the
difference between (a) the fair value of the modified option determined in accordance with the
provisions of this Statement and (b) the value of the old option immediately before its terms are
modified, determined based on the shorter of (1) its remaining expected life or (2) the expected
life of the modified option. Appendix B provides further guidance on and illustrates the accounting
for modifications of both vested and nonvested options.

36. Exchanges of options or changes to their terms in conjunction with business
combinations, spin-offs, or other equity restructurings, except for those made to reflect the terms
of the exchange of shares in a business combination accounted for as a pooling of interests, are
modifications for purposes of this Statement. However, a change to the terms of an award in
accordance with antidilution provisions that are designed, for example, to equalize an option’s
value before and after a stock split or a stock dividend is not a modification of an award for
purposes of this Statement.

Settlements of Awards

37. An entity occasionally may repurchase equity instruments issued to employees after the
employees have vested rights to them. The amount of cash or other assets paid (or liabilities
incurred) to repurchase an equity instrument shall be charged to equity, provided that the amount
paid does not exceed the value of the instruments repurchased. For example, an entity that
repurchases for $10 a share of stock on the date it becomes vested does not incur additional
compensation cost if the market price of the stock is $10 at that date. However, if the market
price of the stock is only $8 at that date, the entity incurs an additional $2 ($10 - $8) of cost. An
entity that settles a nonvested award for cash has, in effect, vested the award, and the amount of
compensation cost measured at the grant date but not yet recognized shall be recognized at the
date of repurchase.

38. For employee stock options, the incremental amount, if any, to be recognized as
additional compensation cost upon cash settlement shall be determined based on a comparison
of the amount paid with the value of the option repurchased, determined based on the remainder
of its original expected life at that date. As indicated in paragraph 37, if stock options are
repurchased before they become vested, the amount of unrecognized compensation cost shall
be recognized at the date of the repurchase.

39. The accounting shall reflect the terms of a stock-based compensation plan as those
terms are mutually understood by the employer and the employees who receive awards under
the plan. Generally, the written plan provides the best evidence of its terms. However, an entity’s
past practice may indicate that the substantive terms of a plan differ from its written terms. For
example, an entity that grants a tandem award consisting of either a stock option or a cash stock
appreciation right (SAR) is obligated to pay cash on demand if the choice is the employee’s, and
the entity thus incurs a liability to the employee. In contract, if the choice is the entity’s, it can
avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity
instrument. However, if an entity that nominally has the choice of settling awards by issuing stock
generally settles in cash, or if the entity generally settles in cash whenever an employee asks for
cash settlement, the entity probably is settling a substantive liability rather than repurchasing an
equity instrument. The substantive terms shall be the basis for the accounting.

40. To restrict control to a limited group, for example, the members of a particular family, a
nonpublic entity may obligate itself to repurchase its equity instruments for their fair value at the
date of repurchase. In practice, such an obligation is not deemed to convert the stock to a
liability. This Statement is not intended to change that view of the effect of a fair value repurchase
agreement for a nonpublic entity. Thus, a nonpublic entity may grant or otherwise issue to
employees equity instruments subject to such a repurchase agreement. The repurchase
agreement does not convert those equity instruments to liabilities, provided that the repurchase
price is the fair value of the stock at the date of repurchase.

Accounting for Tax Consequences of Equity Instruments Awarded to Employees

41. Income tax regulations specify allowable tax deductions for stock-based employee
compensation arrangements in determining an entity’s income tax liability. Compensation cost
recognized under this Statement is measured based on the fair value of an award to an
employee. Under existing U.S. tax law, allowable tax deductions are generally measured at a
specified date as the excess of the market price of the related stock over the amount the
employee is required to pay for the stock (that is, at intrinsic value). The time value component of
the fair value of an option is not tax deductible. Therefore, tax deductions generally will arise in
different amounts and in different periods from compensation cost recognized in financial
statements.

42. The cumulative amount of compensation cost recognized for a stock-based award that
ordinarily results in a future tax deduction under existing tax law shall be considered to be a
deductible temporary difference in applying FASB Statement No. 109, Accounting for Income
Taxes. The deferred tax benefit (or expense) that results from increases (or decreases) in that
temporary difference, for example, as additional service is rendered and the related cost is
recognized, shall be recognized in the income statement. Recognition of compensation cost for
an award that ordinarily does not result in tax deductions under existing tax law shall not be
considered to result in a deductible temporary difference in applying Statement 109. A future
event, such as an employee’s disqualifying disposition of stock under existing U.S. tax law, can
give rise to a tax deduction for an award that ordinarily does not result in a tax deduction. The tax
effects of such an event shall be recognized only when it occurs.

43. Statement 109 requires a deferred tax asset to be evaluated for future realization and to
be reduced by a valuation allowance if, based on the weight of the available evidence, it is more
likely than not that some portion or all of the deferred tax asset will not be realized. Differences
between (a) the deductible temporary difference computed pursuant to paragraph 42 and (b) the
tax deduction inherent in the current fair value of the entity’s stock shall not be considered in
measuring either the gross deferred tax asset of the need for a valuation allowance for a deferred
tax asset recognized under this Statement.
44. If a deduction reported on a tax return for a stock-based award exceeds that cumulative compensation cost for that award recognized for financial reporting, the tax benefit for that excess deduction shall be recognized as additional paid-in capital. If the deduction reported on a tax return is less than the cumulative compensation cost recognized for financial reporting, the write-off of a related deferred tax asset in excess of the benefits of the tax deduction, net of the related valuation allowance, if any, shall be recognized in the income statement except to the extent that there is remaining additional paid-in capital from excess tax deductions from previous stock-based employee compensation awards accounted for in accordance with the fair value based method in this Statement. In that situation, the amount of the write-off shall be charged against that additional paid-in capital.

Disclosures

45. Regardless of the method used to account for stock-based employee compensation arrangements, the financial statements of an entity shall include the disclosures specified in paragraphs 46-48. In addition, an entity that continues to apply Opinion 25 shall disclose for each year for which an income statement is provided the pro forma net income and, if earnings per share is presented, pro forma earnings per share, as if the fair value based accounting method in this Statement had been used to account for stock-based compensation cost. Those pro forma amounts shall reflect the difference between compensation cost, if any, included in net income in accordance with Opinion 25 and the related cost measured by the fair value based method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair value based method had been used. The required pro forma amounts shall reflect no other adjustments to reported net income or earnings per share.

46. An entity with one or more stock-based compensation plans shall provide a description of the plan(s), including the general terms of awards under the plan(s), such as vesting requirements, the maximum term of options granted, and the number of shares authorized for grants of options or other equity instruments. An entity that uses equity instruments to acquire goods or services other than employee services shall provide disclosures similar to those required by this paragraph and paragraphs 47 and 48 to the extent that those disclosures are important in understanding the effects of those transactions on the financial statements.

47. The following information shall be disclosed for each year for which an income statement is provided:

a. The number and weighted-average exercise prices of options for each of the following groups of options: (1) those outstanding at the beginning of the year, (2) those outstanding at the end of the year, (3) those exercisable at the end of the year, and those (4) granted, (5) exercised, (6) forfeited, or (7) expired during the year.

b. The weighted-average grant-date fair value of options granted during the year. If the exercise prices of some options differ from the market price of the stock on the grant date, weighted-average exercise prices and weighted-average fair values of options shall be disclosed separately for options whose exercise price (1) equals, (2) exceeds, or (3) is less than the market price of the stock on the grant date.

c. The number and weighted-average grant-date fair value of equity instruments other than options, for example, shares of nonvested stock, granted during the year.

d. A description of the method and significant assumptions used during the year to estimate the fair values of options, including the following weighted-average information: (1) risk-free interest rate, (2) expected life, (3) expected volatility, and (4) expected dividends.
e. Total compensation cost recognized in income for stock-based employee compensation awards.

f. The terms of significant modifications of outstanding awards.

An entity that grants options under multiple stock-based employee compensation plans shall provide the foregoing information separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity’s use of stock-based compensation. For example, separate disclosure of weighted-average exercise prices at the end of the year for options with a fixed exercise price and those with an indexed exercise price is likely to be important, as would segregating the number of options not yet exercisable into those that will become exercisable based solely on employees rendering additional service and those for which an additional condition must be met for the options to become exercisable.

48. For options outstanding at the date of the latest statement of financial position presented, the range of exercise prices (as well as the weighted-average exercise price) and the weighted-average remaining contractual life shall be disclosed. If the range of exercise prices is wide (for example, the highest exercise price exceeds approximately 150 percent of the lowest exercise price), the exercise prices shall be segregated into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received as a result of option exercises. The following information shall be disclosed for each range:

a. The number, weighted-average exercise price, and weighted-average remaining contractual life of options outstanding

b. The number and weighted-average exercise price of options currently exercisable.

Earnings per Share Implications

49. APB Opinion No. 15, Earnings per Share, requires that employee stock options, nonvested stock, and similar equity instruments granted to employees be treated as common stock equivalents in computing earnings per share. The number of nonvested equity instruments used in computing primary earnings per share shall be the same as the number that are used in measuring the related compensation cost in accordance with this Statement. Fully diluted earnings per share shall continue to be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting is contingent on other factors, such as the level of future earnings, the shares or options shall be treated as contingent shares in accordance with paragraph 62 of Opinion 15. AICPA Accounting Interpretation 91, “Earnings Conditions,” of Opinion 15 provides additional guidance on applying paragraph 62 of Opinion 15 to stock-based employee compensation plans. If stock options or other equity instruments are granted during a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding.

50. In applying the treasury stock method of Opinion 15, the assumed proceeds shall be the sum of (a) the amount, if any, the employee must pay, (b) the amount of compensation cost attributed to future services and not yet recognized, and (c) the Interpretation No. 31, Treatment of Stock Compensation Plans in EPS Computations, provides detailed examples of the treatment of stock compensation plans accounted for under Opinion 25 in earnings per share computations. Although the related cost and tax amounts will differ if the fair value based accounting method in this Statement is applied, the principles in Interpretation 31 remain applicable.

Effective Date and Transition

51. The requirement in paragraph 8 of this Statement shall be effective for transactions entered into after December 15, 1995.
52. The recognition provisions of this Statement may be adopted upon issuance. Regardless of when an entity initially adopts those provisions, they shall be applied to all awards granted after the beginning of the fiscal year in which the recognition provisions are first applied. The recognition provisions shall not be applied to awards granted in fiscal years before the year of initial adoption except to the extent that prior years’ awards are modified or settled in cash after the beginning of the fiscal year in which the entity adopts the recognition provisions. Accounting for modifications and settlements of awards initially accounted for in accordance with Opinion 25 is discussed and illustrated in Appendix B.

53. The disclosure requirements of this Statement shall be effective for financial statements for fiscal years beginning after December 15, 1995, or for the fiscal year for which this Statement is initially adopted for recognizing compensation cost, whichever comes first. The disclosure requirements need not be applied in an interim report unless a complete set of financial statements is presented for that period. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994 need not be included in financial statements for that fiscal year but shall be presented subsequently whenever financial statements for that fiscal year are presented for comparative purposes with financial statements for a later fiscal year.

54. During the initial phase-in period, the effects of applying this Statement for either recognizing compensation cost or providing pro forma disclosures are not likely to be representative of the effects on reported net income for future years, for example, because options vest over several years and additional awards generally are made each year. If that situation exists, the entity shall include a statement to that effect. The entity also may wish to provide supplemental disclosure of the effect of applying the fair value based accounting method to all awards made in fiscal years beginning before the date of initial adoption that were not vested at that date.

RELEVANT LITERATURE

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 78—Employee Stock Ownership Plans
- Issue Paper No. 83—Accounting for Income Taxes

**Generally Accepted Accounting Principles**
- Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 13, Section B,
- Accounting Interpretation of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees
- FASB Statement No. 123, Accounting for Stock-Based Compensation
- FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans
- FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock
- FASB Emerging Issues Task Force Issue No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout
- FASB Emerging Issues Task Force Issue No. 84-18, Stock Option Pyramiding
- FASB Emerging Issues Task Force Issue No. 85-45, Business Combinations, Settlement of Stock Options and Awards
- FASB Emerging Issues Task Force Issue No. 87-6, Adjustments Relating to Stock Compensation Plans
- FASB Emerging Issues Task Force Issue No. 87-23, Book Value Stock Purchase Plans
- FASB Emerging Issues Task Force Issue No. 87-33, Stock Compensation Issues Related to Market Decline
- FASB Emerging Issues Task Force Issue No. 88-6, Book Value Plans in an Initial Public Offering
- FASB Emerging Issues Task Force Issue No. 90-7, Accounting for a Reload Stock Option
- FASB Emerging Issues Task Force Issue No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring
- FASB Emerging Issues Task Force Issue No. 94-6, Accounting for the Buyout of Compensatory Stock Options
- FASB Emerging Issues Task Force Issue No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25
- FASB Emerging Issues Task Force Issue No. 96-3, Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123
- FASB Emerging Issues Task Force Issue No. 96-18, Accounting for Equity Instruments with Variable Terms That Are Issue For Consideration Other Than Employee Services Under FASB Statement No. 123

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 83

Accounting for Income Taxes

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Common Area

SUMMARY OF ISSUE

1. Current statutory accounting principles, as applied to income taxes, generally only reflect a reporting entity’s incurred current taxes and do not consider the tax effects of differences between statutory accounting income and taxable income. While there have always been differences between statutory accounting income and taxable income, tax law changes since 1984 have resulted in greater differences between the two accounting methods. As a result, statutory surplus does not clearly reflect a reporting entity’s ultimate income tax obligation for transactions recorded in the financial statements.

2. GAAP guidance on accounting for income taxes is provided in FASB Statement No. 109, Accounting for Income Taxes (FAS 109).

3. Current statutory accounting guidance is not specific with respect to:
   a. The definition of incurred taxes as it relates to accounting for tax contingencies and the “true-up” portion of the equity tax of mutual life insurance companies and
   b. The criteria for admissibility of income tax recoverables from the Internal Revenue Service (IRS) and the definition of “settled within a reasonable time” as applied to recoverables from a reporting entity’s parent pursuant to a written income tax allocation agreement.

4. The purpose of this paper is to establish statutory accounting principles for income taxes that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

5. For purposes of statutory accounting, “income taxes incurred” includes current income taxes, the amount of federal and foreign income taxes paid (recovered) or payable (recoverable) for the current year. Current income taxes are defined as:
   a. Current year estimates of federal and foreign income taxes (including the equity tax of a mutual life insurer and the “true-up” of such tax), based on tax returns for the current year, and tax contingencies for current and all prior years, to the extent not previously provided, computed in accordance with Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) and
   b. Amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in Issue Paper No. 3—Accounting Changes (Issue Paper No. 3).
6. Additionally, for purposes of statutory accounting, a reporting entity’s Statement of Assets, Liabilities, Surplus and Other Funds, shall include deferred income tax assets (DTAs) and liabilities (DTLs). DTAs and DTLs are the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of FAS 109. FAS 109 is excerpted in paragraph 50 of this issue paper.

7. A reporting entity’s deferred tax assets and liabilities are computed as follows:
   a. Temporary differences are identified and measured using a “balance sheet” approach whereby statutory and tax basis balance sheets are compared,
   b. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that “tax and loss” bonds have been purchased,
   c. Total DTAs and DTLs are computed using enacted tax rates and
   d. Consistent with FAS 109, a DTL is not recognized for amounts described in paragraph 31 of FAS 109.

8. Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus).

9. Gross DTAs shall be admitted in an amount equal to the sum of:
   a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year,
   b. The lesser of:
      i. The amount of gross DTAs, after the application of paragraph 9.a., expected to be realized within one year of the balance sheet date, or
      ii. Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and
   c. The amount of gross DTAs, after the application of paragraphs 9.a. and 9.b., that can be offset against existing DTLs.

10. In computing a reporting entity’s gross DTA pursuant to paragraph 9;
   a. Existing temporary differences that reverse by the end of the subsequent calendar year shall be determined in accordance with paragraphs 228 and 229 of FAS 109;
   b. In determining the amount of federal income taxes that can be recovered through loss carrybacks, the amount and character (i.e., ordinary versus capital) of the loss carrybacks and the impact, if any, of the Alternative Minimum Tax shall be determined in accordance with the provisions of the Internal Revenue Code, and regulations thereunder;
c. The amount of carryback potential that may be considered in calculating the gross DTAs of a reporting entity in subparagraph 9.a. above, that files a consolidated income tax return with one or more affiliates, may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent; and

d. The phrases “reverse by the end of the subsequent calendar year” and “realized within one year of the balance sheet date” are intended to accommodate interim reporting dates and reporting entities that file on an other than calendar year basis for federal income tax purposes.

11. Current income tax recoverables are defined to include all current income taxes, including interest, reasonably expected to be recovered in a subsequent accounting period, whether or not a return or claim has been filed with the taxing authorities. Current income tax recoverables are assets, as defined in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets (Issue Paper No. 4), and are reasonably expected to be recovered if the refund is attributable to an overpayment of estimated tax payments, an error, a carryback, as defined in paragraph 289 of FAS 109, or an item for which the reporting entity has substantial authority, as defined in paragraph 52 of this issue paper.

12. In the case of a reporting entity that files a consolidated income tax return with one or more affiliates, income tax transactions (including payment of tax contingencies to its parent) between the affiliated parties shall be recognized if:

a. Such transactions are economic transactions as defined in Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (Issue Paper No. 25),

b. Are pursuant to a written income tax allocation agreement and

c. Income taxes incurred are accounted for in a manner consistent with the principles of FAS 109, as modified by this issue paper.

Amounts owed to a reporting entity pursuant to a recognized transaction shall be treated as a loan or advance, and nonadmitted, pursuant to Issue Paper No. 25, to the extent that the recoverable is not settled within 90 days of the filing of a consolidated income tax return, or where a refund is due the reporting entity’s parent, within 90 days of the receipt of such refund.

13. Income taxes incurred shall be allocated to net income and realized capital gains or losses in a manner consistent with paragraph 38 of FAS 109. Furthermore, income taxes incurred or received during the current year attributable to prior years shall be allocated, to the extent not previously provided, to net income in accordance with Issue Paper No. 3 unless attributable, in whole or in part, to realized capital gains or losses, in which case, such amounts shall be apportioned between net income and realized capital gains and losses, as appropriate.

14. Income taxes incurred in interim periods shall be computed using an estimated annual effective current tax rate for the annual period in accordance with the methodology described in paragraphs 19 and 20 of Accounting Principles Board Opinion No. 28, Interim Financial Reporting (APB 28). Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on estimates and are subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. If a reporting entity is unable to estimate a part of its “ordinary” income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported. APB 28 is excerpted in paragraph 51 of this issue paper.
15. Statutory financial statement disclosure shall be made in a manner consistent with the provisions of paragraphs 43 - 45 and 48 of FAS 109. However, required disclosures with regard to a reporting entity’s valuation allowance shall be replaced with disclosures relating to the nonadmittance of some portion or all of a reporting entity’s DTAs. Additionally, to the extent that the sum of a reporting entity’s “income taxes incurred” (i.e., current income taxes) and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items. Current statutory financial statement disclosure, as it relates to intercompany tax allocation agreements, is retained. Current statutory financial statement disclosure is excerpted in paragraphs 42 and 43 of this issue paper. Paragraphs 16 to 21 describe the disclosure requirements as modified for the difference between the requirements of FAS 109 and those prescribed by this issue paper.

16. The components of the net DTA or DTL recognized in a reporting entity’s balance sheet shall be disclosed as follows:

   a. The total of all DTAs (admitted and nonadmitted);
   b. The total of all DTLs;
   c. The total DTAs nonadmitted as the result of the application of paragraph 9; and
   d. The net change during the year in the total DTAs nonadmitted.

17. To the extent that DTLs are not recognized for amounts described in paragraph 31 of FAS 109, the following shall be disclosed:

   a. A description of the types of temporary differences for which a DTL has not been recognized and the types of events that would cause those temporary differences to become taxable;
   b. The cumulative amount of each type of temporary difference;
   c. The amount of the unrecognized DTL for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable; and
   d. The amount of the DTL for temporary differences other than those in item c. above that is not recognized in accordance with the provisions of paragraphs 31 of FAS 109.

18. The significant components of income taxes incurred (i.e., current income tax expense) and the changes in DTAs and DTLs shall be disclosed. Those components would include, for example:

   a. Current tax expense or benefit;
   b. The change in DTAs and DTLs (exclusive of the effects of other components listed below);
   c. Investment tax credits;
   d. The benefits of operating loss carryforwards; and
   e. Adjustments of a DTA or DTL for enacted changes in tax laws or rates or a change in the tax status of the reporting entity.
19. Additionally, to the extent that the sum of a reporting entity’s income taxes incurred and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items.

20. A reporting entity shall also disclose the following:
   a. The amounts, origination dates and expiration dates of operating loss and tax credit carryforwards available for tax purposes; and
   b. The amount of federal income taxes incurred in the current year and each preceding year, which are available for recoupment in the event of future net losses.

21. If a reporting entity’s federal income tax return is consolidated with those of any other entity or entities, the following shall be disclosed:
   a. A list of names of the entities with whom the reporting entity’s federal income tax return is consolidated for the current year; and
   b. The substance of the written agreement, approved by the reporting entity’s Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Additionally, the disclosure shall include the manner in which the entity has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

DISCUSSION

22. Statutory accounting principles with respect to income taxes incurred (i.e., current income taxes), as set forth in this issue paper, differ from current statutory guidance as follows:
   a. The definition of current income taxes is clarified by defining such taxes to include current year estimates of federal and foreign income taxes, based on tax returns for the current year, tax contingencies computed in accordance with Issue Paper No. 5, and all amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in Issue Paper No. 3. In the case of a mutual life insurance company, current income tax includes the reporting entity’s best estimate of its equity tax for the current year, after recomputation (i.e., including the “true-up”) in accordance with the guidance contained in Emerging Accounting Issues Working Group Positions 86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies, and 95-3 & 4, Equity Tax.
   b. The definition of current income tax recoverables is modified by defining such amounts as including all current income taxes reasonably expected to be received in a subsequent period, whether or not a return or claim has been filed with the taxing authorities. The criteria for admissibility of current income tax recoverables is also modified by admitting them if they are reasonably expected to be recovered pursuant to Issue Paper No. 4.
   c. Statutory accounting principles with respect to the recognition of income tax transactions between affiliated parties that file a consolidated income tax return are modified to ensure that such transactions are recognized consistently among all reporting entities.
d. Statutory accounting principles with respect to the computation of income taxes incurred in interim periods is modified by requiring the use of the estimated annual effective tax rate for purposes of computed income taxes incurred in interim periods as such a method allows for the comparison of income tax rates among reporting entities, recognizes that an interim period is an integral part of the annual accounting period, and adopts paragraphs 19 and 20 of APB 28.

e. Financial statement disclosure is expanded to include disclosure of the components of current income tax expense, DTAs and DTLs, information as to the portion of a reporting entity’s DTAs that are nonadmitted and, items for which DTLs have not been established in order to provide meaningful information to the users of a reporting entity’s financial statements.

f. Current statutory accounting practice of recording extraordinary amounts of taxes relating to prior years as a component of gains and losses in surplus has been changed to provide that all changes in estimates of income taxes incurred will be recorded in statutory income consistent with Issue Paper No. 3.

23. The definition of current income taxes is clarified to ensure that current income taxes incurred are computed in accordance with the Statement of Concepts, to enhance the comparability of financial statements, and, with respect to the inclusion of tax contingencies, to ensure consistency with the recognition principle of the Statement of Concepts which requires the recognition of liabilities as they are incurred.

24. The definition of current income tax recoverables, and their admissibility, is modified by defining such amounts as including all current income taxes reasonably expected to be received in a subsequent period, whether or not a return or claim has been filed with the taxing authorities, so that such amounts are recorded and admitted based on reasonably objective criteria (i.e., expectation of recovery) and not predicated on subjective criteria (e.g., receipt within a specific timeframe). Current statutory accounting principles’ use of subjective criteria precludes reporting entities that are continually under Internal Revenue Service (IRS) audit pursuant to the Coordinated Examination Program from admitting valid income tax recoverables since the IRS will not refund such amounts until an audit is completed. As a result, many of these taxpayers do not file amended income tax returns but rather present these valid claims to the IRS during the audit as “affirmative adjustments”.

25. The principles of FAS 109, including the recognition of DTAs and DTLs, are adopted with the following modifications:

a. For purposes of this issue paper, income taxes do not include state income taxes. State income taxes (including franchise taxes) shall be computed in accordance with Issue Paper No. 5 and shall be limited to (a) taxes due as a result of the current year’s taxable income calculated in accordance with state laws and regulations and (b) amounts incurred or received during the current year relating to prior periods, to the extent not previously provided as such amounts are deemed to be changes in accounting estimates. Property and casualty insurance companies shall report state income taxes as other underwriting expenses under the caption “Taxes, licenses, and fees.” Life and accident and health insurance companies shall report such amounts as general expense under the “Insurance taxes, licenses, and fees, excluding federal income taxes.” Other health entities shall report such amounts as general administration expenses under the caption “Taxes, licenses, and fees.” State income taxes are excluded from the definition of income taxes to ensure comparability of financial statements, since such taxes are generally not significant to the surplus of a reporting entity and, since not all state taxes are based on income.
b. In order to ensure that a reporting entity’s surplus is conservatively measured, the *more likely than not* criteria of paragraph 17(e) of FAS 109 is replaced by the realization criteria in paragraph 9 of this issue paper.

c. DTAs are not reduced by a valuation allowance. Instead, that portion of a reporting entity’s DTAs that is not realizable pursuant to this issue paper is nonadmitted.

d. Temporary differences do not include AVR, IMR, Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that “tax and loss” bonds have been purchased. Current statutory guidance on the accounting for “tax and loss” bonds is excerpted in paragraph 40 of this issue paper.

e. Changes in DTAs and DTLs, including amounts attributable to changes in tax rates and changes in tax status are not included in net income in accordance with paragraphs 27 and 28 of FAS 109, but rather are allocated to gains and losses in surplus pursuant to this issue paper.

f. Paragraphs 29 - 30, 36 - 37, 39, 41 - 42, 46 and 49 - 59 of FAS 109 are not adopted, inasmuch as they are not applicable to insurance companies or are inconsistent with other statutory accounting principles. Paragraph 47 of FAS 109 is adopted with modification to provide for the disclosures required for non-public reporting entities.

26. The recognition of DTAs and DTLs is consistent with the Statement of Concepts and Issue Paper Nos. 4 and 5, respectively. While Emerging Accounting Issues Working Group Position EI 89-2, Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes allows the recording of DTLs, this issue paper requires the recording of DTLs. In defining the objectives of statutory financial reporting the Statement of Concepts states:

The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

27. Recognition of DTAs and DTLs and the requisite determination that the temporary differences underlying DTAs and DTLs will result in taxable or deductible amounts ensures that statutory surplus reflects the tax consequences of recorded events and is consistent with the assumptions inherent in the financial statements that the reported assets and liabilities will be recovered and settled, respectively. The conclusion reached with respect to the nonadmissibility of Section 847 deposits in Emerging Accounting Issues Working Group Position EI-93-4, Section 847 Deposits, need not be revisited as the tax effect of loss reserve discounting (i.e., a DTA) will be recognized, subject to a nonadmissibility test.

28. DTAs embody the three characteristics of assets, as described in Issue Paper No. 4, for the following reasons:

a. A DTA “embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows” inasmuch as deductible temporary differences reduce taxable income and taxes payable in future years thereby contributing indirectly to future net cash inflows,
b. A reporting entity has exclusive rights to the future benefit associated with its DTA and

c. A DTA is the tax effect of the difference between the tax basis of an asset or liability and its reported amount in the financial statements, and is therefore attributable to a “transaction or other event giving rise to the entity’s right to or control of the benefit [that] has already occurred.”

29. DTLs embody the three characteristics of liabilities, as described in Issue Paper No. 5, for the following reasons:

a. Inasmuch as a DTL stems from a legal obligation imposed by a taxing authority, it “embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand,”

b. While a reporting entity may be able to delay the future reversal of the temporary differences, a DTL embodies a reporting entity’s duty or responsibility to pay a tax “leaving it little or no discretion to avoid the future sacrifice,” and

c. A DTL is the tax effect of the difference between the tax basis of an asset or liability and its reported amount in the financial statements, and is therefore attributable to a “transaction or other event obligating the entity [that] has already happened.”

30. Temporary differences do not include differences, such as AVR, IMR, Schedule F penalties, or tax-exempt interest, inasmuch as these differences do not result in taxable or deductible amounts in future years when the related asset or liability for statutory reporting purposes is recovered or settled. Additionally, IMR is excluded from the definition of temporary differences since it is already net of current taxes paid (i.e., in essence a deferred tax has already been recorded). To the extent that a U.S. mortgage guaranty insurer has purchased “tax and loss” bonds, corresponding amounts of its statutory contingency reserve are excluded from the definition of temporary differences in order to preserve the statutory admissibility of “tax and loss” bonds and to ensure that the tax effect of the reserve is not double counted in a mortgage guaranty insurer’s surplus.

31. By adoption of the principles of FAS 109, as modified in this issue paper, temporary differences include unrealized gains and losses. As a result, unrealized gains and losses of reporting entities shall be recorded, net of any allocated DTA or DTL, in gains and losses in surplus. The amount allocated shall be computed in a manner consistent with paragraph 38 of FAS 109.

32. This statement rejects FASB Interpretation No. 18, Accounting for Income Taxes in Interim Periods…an interpretation of APB Opinion No. 28.

33. The following lists Accounting Principles Board Opinions that are adopted or rejected by this statement:

a. Accounting Principles Board Opinion No. 2, Accounting for the “Investment Credit,” paragraphs 9—15 are adopted with modification to utilize the cost reduction method only and rejects all other paragraphs;

b. Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the “Investment Credit,” is rejected in its entirety;

c. Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966, paragraph 6 is adopted;
d. Accounting Principles Board Opinion No. 23, Accounting for Income Taxes—Special Areas, paragraphs 1—3, 5—9, 12—13, and 15—18 are adopted, and paragraphs 19—25, and 31—33 are rejected;

e. Accounting Principles Board Opinion No. 28, Interim Financial Reporting, paragraphs 19 and 20 are adopted and all other paragraphs rejected;

34. The following lists FASB Technical Bulletins that are adopted or rejected by this statement:

a. FASB Technical Bulletin No. 79-9, Accounting in Interim Periods for Changes in Income Tax Rates is rejected in its entirety;

b. FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases is adopted in its entirety.

35. The following lists FASB Emerging Issues Task Force Issues that are adopted or rejected by this statement:

a. FASB Emerging Issues Task Force No. 91-8, Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax, is rejected in its entirety;

b. FASB Emerging Issues Task Force No. 92-8, Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary, is adopted in its entirety;

c. FASB Emerging Issues Task Force No. 93-13, Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations, is rejected in its entirety;

d. FASB Emerging Issues Task Force No. 93-16, Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23, is rejected in its entirety;

e. FASB Emerging Issues Task Force No. 93-17, Recognition of Deferred Tax Assets for a Parent Company’s Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation, is adopted in its entirety;

f. FASB Emerging Issues Task Force No. 94-10, Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109, is rejected in its entirety;

g. FASB Emerging Issues Task Force No. 95-9, Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109, is rejected in its entirety;

h. FASB Emerging Issues Task Force No. 95-10, Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109, is rejected in its entirety;

i. FASB Emerging Issues Task Force No. 95-20, 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, is rejected in its entirety.
36. This statement rejects *AICPA Accounting Interpretations, Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4* in its entirety.

**Drafting Notes/Comments**
None

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

Beginning with the Revenue Act of 1921, the Internal Revenue Code incorporates certain sections which govern the federal income taxation of property/liability insurance companies. The 1986 Tax Reform Act ("TRI") dramatically changed the manner in which such insurers are taxed, repealing Sections 821 through 826 of the Code and eliminating the differences that previously existed in the taxation of mutual and stock property/liability companies. The taxation of property/liability insurers is governed by Section 831 and 832 of the Internal Revenue Code of 1986.

With the enactment of the TRI, not only were the differences in tax treatment between mutual and stock companies eliminated, but, for the first time, a single property/liability tax return was developed — Form 1120-PC. Gone are the Protection Against Loss ("PAL") account and Form 1120M for mutual property/liability insurers, although provisions concerning the runoff of existing PAL accounts still exist.

Section 832 of the Code continues to define "gross income" as:

“A combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. . .”

Small insurers continue to be eligible for different tax treatment, although they were also affected by the TRI. Any property/liability company with less than $350,000 per year in (the greater of) net written or direct written premiums is exempt from federal income taxation under Code Section 501(c)(15). Property/liability insurers with net written premiums or direct written premiums (whichever is greater) in excess of $350,000, but less than $1,200,000, may make an election to be taxed only on taxable investment income. In the case of a member of a controlled group of corporations, the direct or net written premiums of the controlled group are aggregated in order to determine if the company may make the election. The ownership test for a control group is 50%, rather than 80%, for purposes of determining eligibility for the small company provision.

Each company must establish an appropriate liability for federal income taxes payable in its annual statement. This liability must be sufficient to cover computed taxes for current and prior years that are currently payable (total income tax less estimated tax payments), and any additional taxes the company expects to pay.

This chapter considers the method of accounting for federal income tax, and the differences between annual statement "net income" and “taxable income.”

**Method of Accounting for Federal Income Taxes**

As mentioned above, the statutory method of accounting as used in the annual statement plays the key role in determining the federal income tax liability of property/liability insurers. The insurance sections of the Internal Revenue Code in general provide that taxable income should be computed on the basis of the underwriting and investment exhibits of the annual statement.
except where such basis conflicts with other preemptive provisions of the Code. Such preemptive provisions have been dramatically increased as a result of the 1986 TRA.

**Differences Between Annual Statement “Net Income” and “Taxable Income”**

Due to specific Internal Revenue Code provisions which affect determination of taxable income, there have always been differences between annual statement “net income” and “taxable income,” such as tax exempt interest income, depreciation expense, etc.

The TRA, however, introduced four major provisions at variance with annual statement accounting which increase the taxable income of property/liability insurers:

1. **Discounting of loss reserves.** Property/liability insurers are required to discount loss and loss adjustment expense reserves in the following manner:
   - The discount rate is a moving average of the mid-term applicable federal rate under Code Section 1274, which fluctuates from year to year;
   - The payout period is based on industry averages, but the company may elect to use its own experience;
   - The maximum payout period for former Schedule O lines is three years and ten years for all lines that were reported in Schedule P before the 1989 annual statement; and
   - There is an extension of the 10-year payout period for certain reserves remaining at the end of ten years.

   The impact of discounting is to spread the deduction for ultimate incurred losses and loss adjustment expenses over a number of years to reflect the assumed investment earnings on those reserves.

2. **Revenue Offset.** Property/liability insurers must include in taxable income annually 20% of the increase (decrease) in their unearned premium reserves.

   There is also a transition rule whereby 20% of a company’s unearned premium reserve at the end of 1986 is includable in taxable income ratably over a six year period beginning in 1987.

3. **Proration.** Property/liability insurers are now required to reduce their deduction for losses incurred by 15% of the sum of the tax exempt interest and the deduction for dividends received. This proration rule does not apply to tax exempt interest and the deductible portion of dividends received or accrued on stock or obligations acquired by the insurer before August 8, 1986.

4. **Alternative Minimum Tax.** A new corporate tax concept was introduced wherein a tax is imposed on a company’s “economic” income at a reduced rate of 20%. The corporation’s tax liability will be the higher of the regular tax or this alternative minimum tax.

   Certain tax preference items are added to a company’s (or a group’s) consolidated taxable income resulting in alternative minimum taxable income. Tax preferences should include:
   - 50% of excess of book income over taxable income adjusted for other tax preferences.
   - Interest on certain private activity municipal bonds issued after August 8, 1986.
Accelerated depreciation on real and personal property, to the extent it is in excess of depreciation calculated under an alternative method.

Book income is annual statement net income for mutual insurance companies. For stock insurers that file GAAP financial statements, book income is GAAP net income. Beginning in 1990, this preference will be based on adjusted current earnings (“ACE”), similar to earnings and profits, rather than statutory income. Also in 1990, the preference will equal 75% of the excess of ACE over taxable income, plus other preferences.

(The Superfund Revenue Act of 1986 requires corporations to pay an “environmental” tax, set at an annual rate of $12 per $10,000 of alternative minimum taxable income, payable even if the corporation pays no alternative minimum tax. This tax of .12% is levied on a corporation’s modified alternative minimum taxable income over $2,000,000.)

Other Additions To Annual Statement “Net Income”

Examples of additions are:

1. Provisions for federal income taxes deducted in the annual statement;
2. Excess of realized capital losses over realized capital gains in the annual statement;
3. Gain on sale of capital assets in excess of annual statement gain;
4. Excess of annual statement depreciation and amortization over tax depreciation and amortization;
5. Cost of assets, leasehold improvements, acquisition of leases, and special assessments on real estate owned, which have been included as expenses in the annual statement, but which are capital improvements for tax purposes;
6. Charitable donations exceeding deductible limits;
7. Premiums for officers’ or employees’ life insurance policies where the company is the beneficiary;

Deductions From Annual Statement “Net Income”

Examples of deductions are:

1. Tax-exempt interest as reduced by proration;
2. Dividends received deduction as reduced by proration;
3. Excess of tax depreciation and amortization over annual statement depreciation and amortization;
4. Carry-forward of any allowable deductions, such as excess charitable contributions;
5. Operating or capital loss carry-forwards allowable to the company;
6. Federal income tax refunds included in “net income”;
7. Items previously not deductible for tax purposes that were charged to annual statement in prior years;
8. Loss on sale of capital assets in excess of annual statement loss.
* See above for discounting, revenue offset, proration and anticipation of salvage and subrogation.

Reporting Federal Income Taxes

Federal income taxes can appear in the following places in the annual statement:

Recoverable federal income taxes are allowable as an admitted asset and appear as an asset on the balance sheet. Note, however, that the NAIC does not recognize as an admitted deferred asset "special estimated tax payments" authorized by Section 847 of the Internal Revenue Code.

Federal income taxes due or accrued are included as a liability on the "Liabilities, Surplus and Other Funds" page of the balance sheet.

Federal income taxes incurred during the year are reported as a deduction from income in the Underwriting and Investment Exhibit of the Statement of Income.

Federal income taxes incurred or refunded during the year relating to prior period adjustments are to be included with current year provisions for taxes, but in some instances, if material, they may be charged or credited directly to unassigned surplus in the capital and surplus account.

Also, a footnote to the Statement of Income discloses the amount of federal income taxes incurred and available for recoupment in the event of future net losses. Further, it discloses the amount of any net losses carried forward and available to offset future net income subject to federal income taxes.

Federal income taxes paid are included in the Statement of Changes in Financial Position.

General Interrogatories include a series of questions regarding federal income taxes. They disclose whether a consolidated return is filed and, if so, the methods used to allocate the taxes between the companies. (See Chapter 8-Other Admitted Assets.)

Federal Income Tax Recoverable - Consolidated Return

In the case of an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for federal income tax recoverable should reflect the source of the recoverable such as "Federal Income Tax Recoverable - Parent."

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating on a consolidated tax return provided the following conditions are met:

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and
2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and
3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and
4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and
5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.
Introduction

With the passage of the Deficit Reduction Act of 1984, Congress substantially changed the taxation of life insurance companies under the U.S. Internal Revenue Code. From 1958 through 1983, life insurance companies were taxed under the provisions of the Life Insurance Company Income Tax Act of 1959 which prescribed a complex three phase taxing formula unique to such companies. The 1984 Act mandated a simpler single-phase basis of taxation which essentially parallels the taxation of the income of other corporations. Subsequent modifications have retained the basic single-phase system.

However, there are several aspects of determining life insurance company taxable income that are unique to the life insurance industry. The most notable of these are deductions for increases in life insurance company reserves, deductions for dividends to policyholders, the special treatment of the company’s share of tax exempt interest and dividends received deduction, and the small life insurance company deduction.

Definition of a Life Insurance Company for Federal Income Tax Purposes

To obtain the special treatment afforded life insurance companies under the Internal Revenue Code, a business enterprise must meet the Internal Revenue Code’s definition of a life insurance company. A life insurance company is defined as a company for which, during the taxable year, more than half of its business is the issuance of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies, provided that more than 50% of its total reserves consist of life insurance reserves and unearned premiums and unpaid losses on noncancellable life, accident, or health policies. As a result of this definition in the Internal Revenue Code, companies that are incorporated as life insurance companies under applicable state insurance laws may not qualify as life insurance companies for federal income tax purposes.

Deduction for Increase in Reserves

Life insurance companies are permitted deductions in each tax year for the net amount of the increase in:

- Life insurance reserves (as defined in the Internal Revenue Code).
- Unearned premiums and unpaid losses not included in life insurance reserves.
- Other items set forth in the Internal Revenue Code.

In general, a life insurance reserve is defined in the Internal Revenue Code as a liability amount which is required by state law and which:

- Is computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and
- Recognizes the company’s future liability for unaccrued claims from life insurance, annuity, and noncancellable accident and health insurance contracts. Noncancellable accident and health insurance is defined to include guaranteed renewable accident and health insurance.

Calculation of Life Insurance Reserves for Deduction Purposes

Prior to the 1984 Act, a life insurance company’s reserves for federal income tax purposes were generally based upon those held in its statutory annual statement. As a result of the 1984 Act,
federal standards were established for the calculation of life insurance reserves for income tax purposes and may be summarized as follows:

- The reserve calculation method is specified—in general, a company is to use the Commissioners’ Reserve Valuation Method (CRVM) for life insurance contracts, the Commissioners’ Annuity Reserve Valuation Method (CARVM) for annuity contracts and a two-year full preliminary term for noncancellable accident and health insurance.

- The interest rate is specified—beginning in 1988 it has been the greater of:
  
  An interest rate determined by the Internal Revenue Service based on an average of monthly interest rates for certain Treasury obligations, referred to as the "applicable federal interest rate" (AFR), or
  
  The “prevailing state assumed interest rate”, i.e., the highest interest rate which at least 26 states permit to be used for statutory annual statement reserves for such contracts.

- The mortality/morbidity basis is specified—the “prevailing commissioners’ standard tables for mortality and morbidity”, i.e., the most recent tables adopted by the NAIC which at least 26 states permit to be used for reserve determination for such contracts. In the event there are no “prevailing commissioners’ standard tables”, the Secretary of the Treasury is authorized to specify the mortality or morbidity tables to be used.

Life insurance companies are permitted to use the larger of the reserve amount calculated by the foregoing rules or the net surrender value of the contract to determine the reserve deduction for the tax year. In any event, the tax reserve cannot exceed the reserve amount shown on the company’s annual statement.

As a result of legislation in 1986, certain other reserves which generally are not discounted for annual statement purposes, such as accident and health unpaid claims, now must be discounted for tax deduction purposes using a discounting method and rate specified by the Internal Revenue Code.

Deduction for Policyholder Dividends

As a result of the 1984 Act, the deduction by a stock life insurance company for policyholder dividends paid or accrued during a taxable year generally is not subject to limitation. However, a mutual life insurance company is required by the Internal Revenue Code to reduce its deduction for policyholder dividends (and, next, its deduction for increase in reserves) by an amount referred to as the “differential earnings amount.” According to the 1984 Act Congressional Conference Report, “…This reduction reflects recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies’ earnings to the policyholders as owners…”

The Internal Revenue Code’s definition of “policyholder dividends” includes the following items:

- Amounts returned to policyholders where the amounts so returned were not fixed in the policy but, instead, depended on the experience of the company or the discretion of management.

- Excess interest, defined as any amount in the nature of interest paid or credited to policyholders in excess of the prevailing state assumed interest rate (rather than in excess of the minimum rate guaranteed in the contract).
• Premium adjustments, defined as any reduction in the premiums which would have been required to be paid under the contracts.

• Experience-rated refunds, defined as including a refund based on the experience of the policyholder.

Under the Internal Revenue Code, the differential earnings amount for mutual companies is determined by multiplying an individual company’s “average equity base” for the taxable year by the “differential earnings rate.” The average equity base is an amount calculated by each mutual company. It is based on specific rules in the Internal Revenue Code and includes a company's capital and surplus. The differential earnings rate is computed by the Internal Revenue Service based on information reported by all mutual life insurance companies and the 50 largest stock life insurance companies. The rate for each year is announced by the Internal Revenue Service.

Company’s Share of Tax-Exempt Interest and Dividends-Received Deduction

In determining taxable income for most corporations, tax exempt interest is excluded and a deduction is allowed for a percent of United States source dividend income received. However, special rules apply as to life insurance companies. Life insurance companies are allowed to reduce taxable income by only the “company’s share” of the tax exempt interest and the dividends received deduction. The “company’s share” is calculated using specific rules in the Internal Revenue Code.

Small Life Insurance Company Deduction

For life insurance companies with assets of less than $500 million, a special small company deduction from taxable income is allowed. The deduction is equal to 60% of tentative life insurance company taxable income up to $3 million. This deduction is reduced by 15% of tentative life insurance company taxable income between $3 million and $15 million (at $15 million, the deduction becomes zero). For purposes of the $500 million asset ceiling, all members of a controlled group, including nonlife insurance companies, are treated as one company.

Other Considerations

Alternative Minimum Tax

The Tax Reform Act of 1986 replaced the prior add-on minimum tax with a new alternative minimum tax (AMT) on corporations. The AMT is, in substance, an alternative tax calculation which applies if it exceeds the regular tax.

The AMT is applicable to all companies, including life insurance companies, and is intended to ensure that no taxpayer with substantial economic income can avoid income tax through the use of exclusions, deductions, and credits. The AMT is equal to 20% of the recomputed taxable income that recognizes certain adjustments and items of tax preference. The significant adjustment for life insurance companies for the tax years 1987, 1988, and 1989 was the book income adjustment. This adjustment increases (but does not decrease) the alternative minimum taxable income by 50% of the difference between pretax financial statement income and taxable income. Another adjustment, applicable only to mutual companies, limits the reduction in book income for policyholder dividends.

Starting with 1990, the calculation of alternative minimum taxable income has been based on an earnings and profits concept rather than a book income adjustment. Among the adjustments for tax years beginning after 1989 that are of importance to life insurance companies are a requirement to amortize acquisition costs, the addback of the company’s share of tax exempt interest and the dividends received deduction, and the addback of the small company deduction.
Policyholders’ Surplus Account

A stock life insurance company may be required to maintain a memorandum account for tax purposes called the “policyholders’ surplus account.” The policyholders’ surplus account represents, in effect, income of a stock life insurance company for which tax was deferred under pre-1984 tax rules. Under the 1984 Act, there can be no additions to the policyholders’ surplus account after 1983. However, reductions in the policyholders’ surplus account are included in taxable income in the year in which such reductions occur (referred to as “Phase III income”).

Phase III income can occur as a result of any of the following circumstances:

- The company makes certain distributions to shareholders, either as dividends or redemptions of stock, which are in excess of the shareholders’ surplus account and are considered as reductions of the policyholders’ surplus account.
- The policyholders’ surplus account exceeds certain maximums based on net premiums and life insurance reserves.
- The company ceases to qualify as a life insurance company for tax purposes.

Statutory Treatment of Federal Income Taxes

In addition to United States income taxes, federal income taxes in the annual statement include income taxes levied by foreign countries and United States possessions. The handling of federal income taxes can appear in different places in the annual statement. These places are:

- Federal income tax recoverable is reported as an asset subject to asset admissibility criteria.
- Federal income taxes due or accrued are reported as a liability.
- Federal income taxes incurred during the year (excluding tax on capital gains) are deducted in the Summary of Operations.
- Federal income taxes incurred during the year relating to prior-period adjustments generally are included with current year taxes. However, in extraordinary instances it may be appropriate to charge such adjustments directly to the surplus account.
- Federal income taxes incurred during the year on capital gains are shown as a reduction of Gross Capital Gains and Losses on Investments.

Insurers may recognize transactions arising from income tax allocations among companies participating in a consolidated return, provided certain conditions are met.

39. Chapter 19, Expenses, of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to state income taxes:

Expense Group Classifications

Expenses for fire and casualty insurance companies are allocated to expense groups as follows:

B. Other Underwriting Expenses

Other underwriting expenses are classified into three categories as follows:

3. Taxes, Licenses, and Fees
These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

All other taxes might include: (1) qualifying bond premiums; (2) statement publication fees; (3) advertising required by law; (4) personal property taxes; (5) state income taxes; (6) capital stock taxes; (7) business or corporation licenses or fees; (8) marine profits taxes; (9) documentary stamps on reinsurance; (10) guaranty association assessments; and (11) any other taxes.

Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to “tax and loss” bonds of U.S. mortgage guaranty insurance companies:

**BONDS**

**U.S. Mortgage Guaranty Tax and Loss Bonds**

To obtain a current federal income tax benefit derived from annual additions to the statutory contingency reserve (for tax purposes, the “mortgage guaranty account”), mortgage guaranty insurers must purchase “tax and loss” bonds to the extent of such benefits. These bonds are noninterest bearing obligations of the U.S. Treasury, and mature 10 years after issue. The usual purpose of “tax and loss” bonds is to satisfy taxes that will be due in 10 years when the tax benefit is reversed; however, the bonds may be redeemed earlier in the event of excess underwriting losses. (See chapter on Contingency Reserve.) These bonds are carried as an asset for statutory purposes allowing mortgage insurers to conserve capital.

**FEDERAL INCOME TAXES**

**Contingency Reserve (for Tax Purposes, the “Mortgage Guaranty Account”)**

Under IRS Code Section 832(e), mortgage guaranty insurers are permitted to deduct from gross income the annual addition to the contingency reserve. The tax deduction is generally an amount equal to (a) 50% of earned premium or (b) taxable income as computed prior to this special deduction if less than 50% of earned premium. Annual deductions not utilized for tax purposes during the current period may be carried forward for eight years on a basis similar to net operating losses. The amount deducted must be restored to gross income after ten years; however, the amount may be restored to gross income at an earlier date in the event of a taxable net operating loss.

The tax deduction is permitted only if special “U.S. Mortgage Guaranty Tax and Loss Bonds” are purchased in an amount equal to the tax benefit derived from the deduction (see section on “Bonds”). Upon redemption the “tax and loss” bonds can be used to satisfy the additional tax liability that arises when the deduction is restored to income.

The purchase of “tax and loss” bonds will often defer the entire tax expense that would otherwise be payable on the current year's taxable income.

Chapter 22, General Expenses and Taxes, Licenses and Fees of the Life/A&H Accounting Practices and Procedures Manual contains the following guidance with respect to state income taxes:

**Classification of Expenses**

The following points should be noted with respect to specific classifications of expenses:
12. Taxes, licenses and fees generally include all payments to federal, state, local, and foreign governments with the exception of federal income taxes.

**Taxes, Licenses, and Fees Due or Accrued**

Taxes, licenses, and fees which are unpaid but applicable to the accounting period should be accrued and reported as a liability in the balance sheet. With respect to premium taxes and state income taxes, the amount accrued should relate to the related premiums or taxable income recorded in the period, less, of course, prepayments of those taxes. Payroll taxes accrued should include all unpaid taxes applicable to salaries and wages which have been paid, plus taxes applicable to accrued payroll.

42. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provides the following guidance with respect to federal income taxes:

**UNDERWRITING AND INVESTMENT EXHIBIT**

**STATEMENT OF INCOME**

**Line 15 - Federal and Foreign Income Taxes Incurred**

Include: Current year provisions for federal and foreign income taxes, and federal and foreign income taxes incurred or refunded during the year relating to prior period adjustments. In some instances such prior period adjustments, if material, may be charged or credited directly to Unassigned Surplus in the “Capital and Surplus Account.”

The statutory method of accounting as used in the annual statement plays the key role in determining the federal income tax liability of property and casualty insurance companies. The insurance sections of the Internal Revenue Code, in general, provide that taxable income should be computed on the basis of the underwriting and investment exhibits of the annual statement except where such basis conflicts with other preemptive provisions of the Internal Revenue Code.

The amount of this item equals Line 14 of Exhibit 2, adjusted for reserves in Line 6 on page 3 of the current and prior years’ statements, and recoverables in Line 14, Column 4 on Page 2 of current and prior years’ statements.

The amount of this item equals Line 9, Page 5, adjusted for reserves in Line 6 on Page 3 of the current and prior years’ statements, and recoverables in Line 14, Column 4 on Page 2 of current and prior years’ statements.

**CAPITAL AND SURPLUS ACCOUNT**

**Line 29 - Extraordinary Amounts of Taxes for Prior Years**

Include: Interest and expenses related to prior year taxes on this line.
Line 14 - Federal Income tax Recoverable

In the case on an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for Federal Income Tax Recoverable should reflect the source of the recoverable; e.g., Federal Income Tax Recoverable - Parent.

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating in a consolidated income tax return, provided the following conditions are met:

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and
2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and
3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and
4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and
5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

NOTES TO FINANCIAL STATEMENTS


Instruction:

a. If the company's federal income tax return is combined with those of any other entity or entities, provide the following:

1. A list of names of the entities with whom the company's federal income tax return is combined for the current year.
2. The substance of the written agreement, approved by the company's Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Describe the method of allocation, setting forth the manner in which the company has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

b. If the company incurred federal income taxes which are available for recoupment in the event of future net losses, indicate the amount available for recoupment from the current year, the first preceding year, and the second preceding year.

c. If the company incurred net losses which are carried forward and are available to offset future net income subject to income taxes, indicate the amounts carried
forward from the current year and each of the six years preceding the current year.

Illustration:

1. The Company’s federal income tax return is combined with the following entities:

   The Affiliated Company

2. The method of allocation between the companies is subject to written agreement, approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually in the first quarter.

b. The amount of federal income taxes incurred and available for recoupment in the event of future net losses is:
   
   current year $ ________;  first preceding year $ ________;
   second preceding year $ ________

c. The amount of net losses carried forward and available to offset future net income subject to federal income taxes is:
   
   current year $ ________;  first preceding year $ ________;
   second preceding year $ ________;  third preceding year $ ________;
   fourth preceding year $ ________;  fifth preceding year $ ________;
   sixth preceding year $ ________

43. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies provides the following guidance with respect to federal income taxes:

SUMMARY OF OPERATIONS (EXCLUDING UNREALIZED CAPITAL GAINS & LOSSES)

Line 30 - Federal Income Taxes Incurred

Include: Income and excess profits taxes, of any foreign country or of any possession of the U.S., incurred on operations.

Exclude: Taxes on capital gains and Extraordinary amounts of taxes relating to prior years.

The total of the amount in Line 30 minus extraordinary amounts of taxes reported in the “Details of Write-ins Aggregated at Line 46 for Gains and Losses in Surplus” on Line 46 plus Exhibit 3, Footnote (a), Line 1, Column B should be equal to Exhibit 12, Line 23.2 plus Page 3, Line 14A, current year, plus Page 2, Line 14, prior year, minus Page 3, Line 14A, prior year, minus Page 2, Line 14, Column 4, current year.

ASSETS, PAGE 2

Line 14 - Federal Income Tax Recoverable

In the case on an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for Federal Income Tax Recoverable should reflect the source of the recoverable; e.g., Federal Income Tax Recoverable - Parent.

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating in a consolidated income tax return, provided the following conditions are met:
1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and

2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and

3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and

4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and

5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

NOTES TO FINANCIAL STATEMENTS

5. Federal Income Tax Allocation

Instruction:

If the company’s federal income tax return is combined with those of any other entity or entities, provide the following:

a. A list of names of the entities with whom the company’s federal income tax return is combined for the current year.

b. The substance of the written agreement, approved by the company’s Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Describe the method of allocation, setting forth the manner in which the company has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

Illustration:

a. The Company’s federal income tax return is combined with the following entities:

   The Affiliated Company

b. The method of allocation between the companies is subject to written agreement, approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually in the first quarter.

44. Emerging Accounting Issues Working Group Position EI-86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies, provides the following guidance:

   True-Up of Federal Income Taxes for Mutual Life Insurance Companies

   The second issue discussed was adjustment of the ownership differential earnings amount provided under the Deficit Reduction Act of 1984. Attached to these minutes is a memorandum prepared by Ernst & Whinney which provided the background material for the discussion.
Accounting issues discussed were as follows:

1. What is the most appropriate option for mutual life insurers to adopt in accruing for 1984 and 1985 in the absence of an announced differential rate by the U.S. Treasury?

2. Should the adjustments to federal income taxes of prior years’ tax liability relative to the true-up be reported through operations or as a direct charge to surplus?

The working group concluded the following:

1. “Best estimates” should be used in accruing for the 1984 and 1985 tax liabilities in the absence of an announced differential rate by the U.S. Treasury.

2. Adjustments of prior years’ tax liability relative to the true-up should be reported through the operations statement.

45. Emerging Accounting Issues Working Group Position EI 87-6, Accounting for the Impact of the Tax Reform Act of 1986, provides the following guidance (However, note that reference to the FASB relates to consideration of deferred taxes pursuant to FASB Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes, which was superseded by FAS 109):

Accounting for Impact of the Tax Reform Act of 1986 (Loss Reserves Discounting)

The question of accounting on a statutory basis for the implications of tax reform was initially raised by Mary Jan Robertson, Vice President–Controller of United Capital Insurance Company. Subsequent to, and, independent of her request, tax reform impact questions were also referred to the Emerging Issues Working Group by action of the Financial Condition (EX4) Subcommittee.

The Tax Reform Act of 1986 made significant changes in the taxation of property and casualty insurance companies. Among the changes are “fresh start” provisions, loss reserve discounting, limitation in the deduction of the unearned premium, taxation of a portion of previously tax-exempt income, imposition of an alternative minimum tax in some cases and lower rates. The act changes the timing of tax payments and taxable income may be considerably higher than before, particularly in the first few years:

The working group considered the following issues:

1. Should the loss reserve discounting required for federal tax purposes be reflected in the insurer’s statutory statement?

   The working group concluded that loss reserve discounting required for federal tax purposes was not an acceptable statutory accounting treatment.

2. Should a deferred tax asset, i.e., prepaid income taxes, arising from current timing differences be permitted on a statutory basis?

   The consensus of the working group was that a deferred tax asset should not be permitted for statutory accounting purposes. The consensus was based, among other things, on the following:

   a. The asset is not convertible to cash; it generally only reflects timing differences.

   b. The asset is not recoverable within a definitive and short (1 to 2 years) time frame nor is the value readily determinable.

   c. Statutory accounting has not previously recognized prepaid or deferred liability items (e.g., prepaid rent and deferred acquisition expenses).
d. In the majority of companies, i.e., those with growing premium volume and increasing loss reserve levels, the deferred tax asset would continually grow, probably to a very significant size.

The Financial Accounting Standard Board (FASB) has also reviewed this issue. FASB may allow some balance sheet recognition of a deferred tax asset, but it will be limited to a 3-year carryback amount if the amount and calculation thereof is clearly demonstrable. The working group believes in most cases, this will provide insignificant relief to property/casualty insurers.

The working group recommends to all insurance departments and to the NAIC Examiner Team that their financial analysis process take into consideration the impact on surplus caused by the new tax law. In some cases, effective tax rates will be very high, in excess of 100%, and that obviously will impact surplus. As a result, IRIS tests and other financial ratios which are surplus dependent may be distorted. Examiners and analysts should be cognizant of tax impact when evaluating companies. In certain situations, analytical recognition of additional equity resulting from deferred or prepaid taxes should be considered when determining financial stability and writing capacity. The working group believes this will be very pertinent with respect to new, growing companies writing long tail lines and to small, monoline, professional malpractice companies.

46. Emerging Accounting Issues Working Group Position EI 89-2, Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes, provides the following guidance on deferred taxes:

Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes

The issue summary for this topic was also prepared by Mr. Schaefer of the Michigan Insurance Bureau. A Michigan property and casualty insurer had established a liability for deferred federal income taxes consisting of a protection against loss account, unrealized gains from securities purchased at a discount and unrealized gains or losses from the write-up or write-down of the market value on stocks. While statutory accounting allows the deferral of taxes through the establishment of a P.A.L. account, the 1986 Tax Reform Act repealed the deduction for such an account.

The issue identified was:

Should the reporting of a liability for deferred federal income taxes be allowed under statutory accounting principles?

The working group concluded that while the existing accounting does not prohibit the establishment of a deferred tax liability, such a liability is not required. If an insurer does establish such a liability, it should be done on a consistent basis from year to year. In accordance with present annual statement instructions, it should not be included in the federal income tax liability.

47. Emerging Accounting Issues Working Group Position EI 93-4, Section 847 Deposits, provides the following guidance on the asset admissibility of these deposits:

2. Section 847 Deposits (Prepaid Federal Income Taxes)

This issue submitted by Dakota Truck Underwriters (Attachment B) was first considered by the working group in September 1993 (EI 93-3). The discussion at that meeting revealed that additional research was needed to provide information to the working group. John Baily (Coopers & Lybrand) summarized the result of such research (Attachment C). He indicated that this issue was not unlike the general issue of deferred tax assets considered and rejected by the working group previously.
The working group voted to reject the recommendation to allow reciprocal insurers an admitted asset for Section 847 deposits. The working group also reiterated its position against deferred taxes for statutory purposes.

48. Emerging Accounting Issues Working Group Position EI 95-3, *Equity Tax*, provides the following guidance on statutory accounting for a mutual life insurer’s equity tax:

Norris Clark (Calif.) summarized an issue submitted by Martin Carus (N.Y.) (Attachment A) regarding a component of federal income taxes for mutual life insurance companies commonly referred to as the “equity tax.” The question is whether it is more appropriate to charge that component of federal income taxes directly to surplus or through operations as income tax expense.

Armand de Palo (The Guardian Life Insurance Company of America) was recognized to present some additional information in support for charging the “equity tax” directly to surplus (Attachment B). Mr. Clark distributed minutes from a 1986 meeting of the working group (Attachment C) that include a discussion of this topic, and a recent letter received from John J. Palmer (Life of Virginia) concerning the issue (Attachment D).

After further discussion, the working group reached a tentative consensus that this component of federal income taxes should be recorded as tax expense in the summary of operations and should not be charged directly to surplus. The issue will be further discussed at the Winter National Meeting in San Antonio in anticipation of reaching a final consensus.

49. Emerging Accounting Issues Working Group Position EI 95-4, *Equity Tax*, provides the following guidance on statutory accounting for a mutual life insurer’s equity tax:

1. **Equity Tax**

Norris Clark (Calif.) summarized the issue and reviewed the preliminary consensus from the Fall National Meeting that the component of federal income taxes known as the “equity tax” should be recorded as tax expense in the summary of operations and should not be charged directly to surplus.

After further discussion the working group affirmed the preliminary conclusion.

**Generally Accepted Accounting Principles**

50. FAS 109 provides the following relevant guidance:

**STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING**

**SCOPE**

3. This Statement establishes the standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of:

   a. Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income
   b. Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting
   c. Operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years.

**Objectives and Basic Principles**

6. One objective of accounting for income taxes is to recognize the amount of taxes payable or refundable for the current year. A second objective is to recognize deferred tax liabilities and
assets for the future tax consequences of events\(^3\) that have been recognized in an enterprise’s financial statements or tax returns.

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\(^3\) Some events do not have tax consequences. Certain revenues are exempt for taxation and certain expenses are not deductible. In the United States, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.

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7. Ideally, the second objective might be stated more specifically to recognize the *expected* future tax consequences of events that have been recognized in the financial statements or tax returns. However, the objective is realistically constrained because (a) the tax payment or refund that results from a particular tax return is a joint result of all the items included in that return, (b) taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years, and (c) information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.

8. To implement the objectives in light of these constraints, the following basic principles (the only exceptions are identified in paragraph 9) are applied in accounting for income taxes at the date of the financial statements:

   a. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
   b. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
   c. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted law; the effects of future changes in tax laws or rates are not anticipated.
   d. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

9. The only exceptions in applying those basic principles are that this Statement:

   a. Continues certain exceptions to the requirements for recognition of deferred taxes for the areas addressed by APB Opinion No. 23, *Accounting for Income Taxes - Special Areas*, as amended by this Statement (paragraphs 31-34)
   b. Provides special transitional procedures for temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises (paragraph 32)
   c. Does not amend accounting for leveraged leases as required by FASB Statement No. 13, *Accounting for Leases*, and FASB Interpretation No. 21, *Accounting for Leases in a Business Combination* (paragraphs 256-258)
   d. Prohibits recognition of a deferred tax liability or asset related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (paragraph 30)
   e. Does not amend Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, for income taxes paid on intercompany profits on assets remaining within the group, and prohibits recognition of a deferred tax asset for the difference between the tax basis of the assets in the buyer’s tax jurisdiction and their cost as reported in the consolidated financial statements.
   f. Prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under FASB Statement No. 52, *Foreign Currency Translation*, are remeasured from the local currency into the functional currency using historical exchange rates that result from (1) changes in exchange rates or (2) indexing for tax purposes.
Temporary Differences

10. Income taxes currently payable\(^4\) for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

a. The amount of taxable income and pretax financial income for a year
b. The tax bases of assets or liabilities and their reported amounts in financial statements.

\(^4\) References in this Statement to income taxes currently payable and (total) income tax expense are intended to include also income taxes currently refundable and (total) income tax benefit, respectively.

11. An assumption inherent in an enterprise’s statement of financial position prepared in accordance with generally accepted accounting principles is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples follow:

a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.

b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.

c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.

d. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

e. A reduction in the tax basis of depreciable assets because of tax credits. \(^5\) Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

f. ITC accounted for by the deferral method. Under Opinion 2, ITC is viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred ITC may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.
g. An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency. The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

h. Business combinations accounted for by the purchase method. There may be differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination accounted for as a purchase under APB Opinion No. 16, Business Combinations. Those differences will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively.

5 The Tax Equity and Fiscal Responsibility Act of 1982 provided taxpayers with the choice of either (a) taking the full amount of Accelerated Cost Recovery System (ACRS) deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or (b) taking the full tax credit and a reduced amount of ACRS deductions.

Recognition and Measurement

16. An enterprise shall recognize a deferred tax liability or asset for all temporary differences and operating loss and tax credit carryforwards in accordance with the provisions of paragraph 17. Deferred tax expense or benefit is the change during the year in an enterprise’s deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.

6 Refer to paragraph 9. A deferred tax liability shall be recognized for the temporary differences addressed by Opinion 23 in accordance with the requirements of this Statement (paragraphs 31-34) and that Opinion, as amended.

7 Paragraph 230 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred tax liability or asset when the reporting currency is the functional currency.

17. Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

a. Identify (1) the types and amounts of existing temporary differences and (2) the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period
b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (paragraph 18)
c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate
d. Measure deferred tax assets for each type of tax credit carryforward
e. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.
18. The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat rate. That rate shall be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor. Enterprises for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

19. In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 17(d) and (e) of this Statement. If alternative tax systems exist in jurisdictions other than the U.S. federal jurisdiction, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction (that is, a mechanism similar to the U.S. alternative minimum tax credit) between the two systems.

20. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.

21. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

   a. Future reversals of existing taxable temporary differences
   b. Future taxable income exclusive of reversing temporary differences and carryforwards
   c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law
   d. Tax-planning strategies (paragraph 22) that would, if necessary, be implemented to, for example:
      (1) Accelerate taxable amounts to utilize expiring carryforwards
      (2) Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
      (3) Switch from tax-exempt to taxable investments.

   Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

22. In some circumstances, there are actions (including elections for tax purposes) that (a) are prudent and feasible, (b) an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization
of deferred tax assets. This Statement refers to those actions as tax-planning strategies. An enterprise shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. Refer to paragraphs 246-251 for additional guidance.

23. Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include (but are not limited to) the following:
   a. A history of operating loss or tax credit carryforwards expiring unused
   b. Losses expected in early future years (by a presently profitable entity)
   c. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years
   d. A carryback, carryforward period that is so brief that it would limit realization of tax benefits if (1) a significant deductible temporary difference is expected to reverse in a single year or (2) the enterprise operates in a traditionally cyclical business.

24. Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include (but are not limited to) the following:
   a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
   b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
   c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

25. An enterprise must use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset.

An Enacted Change in Tax Laws or Rates

27. Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

A Change in Tax Status of an Enterprise

28. An enterprise's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset shall be recognized for temporary differences in accordance with the requirements of this Statement at the date that a nontaxable enterprise becomes a taxable enterprise. A deferred tax liability or asset shall be eliminated at the date an enterprise ceases to be a taxable enterprise. In either case, the effect of (a) an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and (b) a change in tax status that results from a change in tax law is recognized on the enactment date.
The effect of recognizing or eliminating the deferred tax liability or asset shall be included in income from continuing operations.

**Opinion 23 and U.S. Steamship Enterprise Temporary Differences**

31. A deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

   a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture as defined in *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock*, that is essentially permanent in duration.

   b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992\(^9\)

   c. “Bad Debt reserves” for tax purposes of U.S. savings and loan associations (and other “qualified thrift lenders”) that arose in tax years beginning before December 31, 1987 (that is, the base year amount)

   d. “Policyholders’ surplus” of stock life insurance companies that arose in fiscal years beginning on or before December 15, 1992.

   The indefinite reversal criterion of Opinion 23 shall not be applied to analogous types of temporary differences.

   \(^9\) A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992.

32. A deferred tax liability shall be recognized for the following types of taxable temporary differences:

   a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992

   b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 31(a) and (b) for a corporate joint venture that is essentially permanent in duration

   c. “Bad debt reserves” for tax purposes of U.S. savings and loan associations (and other “qualified thrift lenders”) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

   The tax effects of temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises that arose in fiscal years beginning on or before December 15, 1992 and that were not previously recognized shall be recognized when those temporary differences reverse or in their entirety at the beginning of the fiscal year for which this Statement is first applied.

33. Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference must be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. For example, under current U.S. federal tax law:
a. An enterprise may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the parent company's tax basis for the stock of that subsidiary.

b. An enterprise may execute a statutory merger whereby a subsidiary is merged into the parent company, the minority shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business enterprise, and certain other requirements of the tax law are met.

Some elections for tax purposes are available only if the parent company owns a specified percentage of the subsidiary's stock. The parent company sometimes may own less than that specified percentage, and the price per share to acquire a minority interest may significantly exceed the per share equivalent of the amount reported as minority interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the minority interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the minority interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash.

34. A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. The need for a valuation allowance for that deferred tax asset and other deferred tax assets related to Opinion 23 temporary differences (for example, a deferred tax asset for foreign tax credit carryforwards or for a savings and loan association's bad-debt reserve for financial reporting) shall be assessed. Paragraph 21 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences. Future reversals of taxable differences for which a deferred tax liability has not been recognized based on the exceptions cited in paragraph 31, however, shall not be considered. Another source is future taxable income exclusive of reversing temporary differences and carryforwards. Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.

Intraperiod Tax Allocation

35. Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (paragraph 36). The amounts allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (a) changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (paragraph 26), (b) changes in tax laws or rates (paragraph 27), (c) changes in tax status (paragraph 28), and (d) tax-deductible dividends paid to shareholders (except as set forth in paragraph 36 for dividends paid on unallocated shares held by an employer stock ownership plan [ESOP] or any other stock compensation arrangement). The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraph 38.

36. The tax effects of the following items occurring during the year are charged or credited directly to related components of shareholders' equity:

a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error.
b. Gains and losses included in comprehensive income but excluded from net income (for example, translation adjustments under Statement 52 and changes in the carrying amount of marketable securities under FASB Statement No. 12, Accounting for Certain Marketable Securities)

c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock)

d. An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination

e. Expenses for employee stock options recognized differently for financial reporting and tax purposes (refer to paragraph 17 of APB Opinion No. 25, Accounting for Stock Issued to Employees)

f. Dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings

g. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization (except as set forth in paragraph 39).

37. The tax benefit of an operating loss carryforward or carryback (other than those carryforwards referred to at the end of this paragraph) shall be reported in the same manner as the source of the income or loss in the current year and not in the same manner as (a) the source of the operating loss carryforward or taxes paid in a prior year or (b) the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. The only exceptions are as follows:

a. Tax effects of deductible temporary differences and carryforwards that existed at the date of a purchase business combination and for which a tax benefit is initially recognized in subsequent years in accordance with the provisions of paragraph 30

b. Tax effects of deductible temporary differences and carryforwards that are allocated to shareholders’ equity in accordance with the provisions of paragraph 36 (items (c) and (e)-(g)).

38. If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items

b. Apportion the tax benefit determined in (a) ratably to each net loss item

c. Determine the amount that remains, that is, the difference between (1) the amount to be allocated to all items other than continuing operations and (2) the amount allocated to all net loss items

d. Apportion the tax expense determined in (c) ratably to each net gain item.

39. The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in ARB No. 43, Chapter 7, “Capital Accounts,” ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years. The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by
paragraph 37 (without regard to the referenced exceptions) and then reclassified from retained earnings to contributed capital. Those enterprises should disclose (a) the date of the quasi reorganization, (b) the manner of reporting the tax benefits and that it differs from present accounting requirements for other enterprises and (c) the effect of those tax benefits on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts).

Separate Financial Statements of a Subsidiary

40. The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer\(^{10}\) meets those criteria. Examples of methods that are not consistent with the broad principles established by this Statement include:

a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences

b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Statement (for example, the Opinion 11 deferred method)

c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

\(^{10}\) In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amounts. That may also be the result when there are intercompany transactions between members of the consolidated group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

41. In a classified statement of financial position, an enterprise shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting (paragraph 15), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal date of the temporary difference pursuant to \textit{FASB Statement No. 37, Balance Sheet Classification of Deferred Income Taxes}. The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

42. For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets shall be offset and presented as a single amount and (b) all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

Financial Statement Disclosure

43. The components of the net deferred tax liability or asset recognized in an enterprise’s statement of financial position shall be disclosed as follows:

a. The total of all deferred tax liabilities measured in procedure (b) of paragraph 17
b. The total of all deferred tax assets measured in procedures (c) and (d) of paragraph 17

c. The total valuation allowance recognized for deferred tax assets determined in procedure (e) of paragraph 17.

The net change during the year in the total valuation allowance also shall be disclosed. A public enterprise shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances). A nonpublic enterprise shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type. A public enterprise that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the enterprise’s assets and liabilities.

44. The following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Opinion 23 (as amended by this Statement) or for deposits in statutory reserve funds by U.S. steamship enterprises:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable

b. The cumulative amount of each type of temporary difference

c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable

d. The amount of the deferred tax liability for temporary differences other than those in (c) above (that is, undistributed domestic earnings, the bad-debt reserve for tax purposes of a U.S. savings and loan association or other qualified thrift lender, the policyholders’ surplus of a life insurance enterprise, and the statutory reserve funds of a U.S. steamship enterprise) that is not recognized in accordance with the provisions of paragraphs 31 and 32.

45. The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

a. Current tax expense or benefit

b. Deferred tax expense or benefit (exclusive of the effects of other components listed below)

c. Investment tax credits

d. Government grants (to the extent recognized as a reduction of income tax expense)

e. The benefits of operating loss carryforwards

f. Tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity

g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise

h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years.

46. The amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items (in accordance with the provisions of paragraphs 35-39) shall be disclosed for each year for which those items are presented.
47. A public enterprise shall disclose a reconciliation using percentages or dollar amounts of (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The “statutory” tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed. A nonpublic enterprise shall disclose the nature of significant reconciling items but may omit a numerical reconciliation. If not otherwise evident from the disclosures required by this paragraph and paragraphs 43-46, all enterprises shall disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented.

48. An enterprise shall disclose (a) the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes and (b) any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital (paragraphs 30 and 36).

49. An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:
   a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented
   b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented.

Effective Date and Transition

50. This Statement shall be effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged. Financial statements for any number of consecutive fiscal years before the effective date may be restated to conform to the provisions of this Statement. Initial application of this Statement shall be as of the beginning of an enterprise's fiscal year (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated). Application of the requirements for recognition of a deferred tax liability or asset for a restated interim or annual period shall be based on the facts and circumstances as they existed at that prior date and without the benefit of hindsight.

51. The effect of initially applying this Statement shall be reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle (APB Opinion No. 20, Accounting Changes, paragraph 20) except for initially recognized tax benefits of the type required by this Statement to be excluded from comprehensive income. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings and, if necessary, any other components of shareholders' equity for the earliest year presented shall be adjusted for the effect of the restatement as of that date. Paragraph 30 addresses the manner of reporting acquired tax benefits initially recognized subsequent to a business combination and paragraph 36 identifies five items ((c)-(g)) for which tax benefits are excluded from comprehensive income and allocated directly to contributed capital or retained earnings. Pro forma effects of retroactive application (Opinion 20, paragraph 21) are not required if statements of earnings presented for prior years are not restated.

52. When initially presented, the financial statements for the year this Statement is first adopted shall disclose:
a. The effect, if any, of adopting this Statement on pretax income from continuing operations (for example, the effect of adjustments for prior purchase business combinations and for regulated enterprises) for the year of adoption if restated financial statements for the prior year are not presented.

b. The effect of any restatement on income from continuing operations, income before extraordinary items, and net income (and on related per share amounts) for each year for which restated financial statements are presented.

Prior Business Combinations

53. If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years shall be remeasured in accordance with the requirements of this Statement.

54. For a purchase business combination consummated prior to the beginning of the year for which this Statement is first applied, any balance remaining as of that date for goodwill or negative goodwill shall not be adjusted to equal the amount it would be if financial statements for the year of the combination and subsequent years were restated. However, except for leveraged leases and except as provided in paragraph 55, (a) remaining balances as of the date of initially applying this Statement for assets and liabilities acquired in that combination shall be adjusted from their net-of-tax amounts to their pretax amounts and (b) any differences between those adjusted remaining balances and their tax bases are temporary differences. A deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

55. If, for a particular business combination, determination of the adjustment for any or all of the assets and liabilities referred to in paragraph 54 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, none of the remaining balances of any assets and liabilities acquired in that combination shall be adjusted to pretax amounts, that is, all remaining amounts that were originally assigned on a net-of-tax basis pursuant to paragraph 89 of Opinion 16 shall not be adjusted. Any differences between those unadjusted remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

56. The net effect of the adjustments required by paragraphs 54 and 55 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

Assets of Regulated Enterprises Reported on a Net-of-Tax or After-Tax Basis

57. Some regulated enterprises that apply Statement 71 have accounted for certain components of construction in progress on either a net-of-tax or after-tax basis, or both. Upon initial application of this Statement, those enterprises shall make appropriate adjustments required by this Statement to account for the net-of-tax and after-tax components of construction in progress as if the requirements of this Statement were applied to that construction in progress in all prior years. Except as provided in paragraph 58, the reported amount of plant in service at the beginning of the year for which this Statement is first applied shall be similarly adjusted.

58. If determination of the adjustment to plant in service referred to in paragraph 57 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, any difference between the reported amount and the tax basis of that plant in service is a temporary difference, and a deferred tax liability shall be recognized for that temporary difference. If, as a result of an action by a regulator, it is probable that amounts required for settlement of that deferred tax liability will be recovered from customers through future rates, an asset and the related deferred tax liability for that additional temporary difference shall be recognized for that probable future revenue.
59. The net effect of the adjustments required by paragraphs 57 and 58 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

289. GLOSSARY

Carrybacks

Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.

Carryforwards

Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year.

51. APB 28 provides the following guidance (However, note that FAS 109 supersedes APB Opinion Nos. 11 and 24 and amends APB Opinion No. 23);

19. In reporting interim financial information, income tax provisions should be determined under the procedures set forth in APB Opinion Nos. 11, 23, and 24. At the end of each interim period the company should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this effective tax rate no effect should be included for the tax related to significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year. ²

² Disclosure should be made of the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business (refer to FASB Statement No. 109, Accounting for Income Taxes, paragraph 47).

20. The tax effects of losses that arise in the early portion of a fiscal year should be recognized only when the tax benefits are expected to be (a) realized during the year or (b) recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Statement 109. An established seasonal pattern of loss in early interim periods offset by income in later interim periods should constitute evidence that realization is more likely than not, unless other evidence indicates the established seasonal pattern will not prevail. The tax effects of losses incurred in early interim periods may be recognized in a later interim period of a fiscal year if their realization, although initially uncertain, later becomes more likely than not. When the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision should be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized. ³ The tax effect of a valuation allowance expected to be necessary for a deferred tax asset at the end of the year for originating deductible temporary differences and carryforwards during the year should be included in the effective tax
rate. The effect of a change in the beginning-of-the-year balance of a valuation allowance as a result of a change in judgment about the realizability of the related deferred tax asset in future years shall not be apportioned among interim periods through an adjustment of the effective tax rate but shall be recognized in the interim period in which the change occurs. The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be reflected after the effective dates prescribed in the statutes in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a deferred tax liability or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate. The tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year shall be recognized as of the enactment date of the change as tax expense (benefit) for the current year.

3 The tax benefits of interim losses accounted for in this manner would not be reported as extraordinary items in the results of operations of the interim period.

OTHER SOURCES OF INFORMATION

52. Federal Income Tax Regulation Section 1.6662-4(d) provides the following guidance:

(d) Substantial authority (1) Effect of having substantial authority. If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to the item is not included in the understatement for that year. (For special rules relating to tax shelter items see section 1.6662-4(g).)

(2) Substantial authority standard. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the "more likely than not" standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard (the standard which, if satisfied, generally will prevent imposition of the penalty under section 6662(b)(1) for negligence). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) Determination of whether substantial authority is present. (i) Evaluation of authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

(ii) Nature of analysis. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is
accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- Issue Paper No. 3—Accounting Changes
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Emerging Accounting Issues Working Group Position EI 86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies
- Emerging Accounting Issues Working Group Position EI 87-6, Accounting for the Impact of the Tax Reform Act of 1986
- Emerging Accounting Issues Working Group Position EI 93-4, Section 847 Deposits
- Emerging Accounting Issues Working Group Position EI 95-3, Equity Tax
- Emerging Accounting Issues Working Group Position EI 95-4, Equity Tax

Generally Accepted Accounting Principles
- FASB Statement No. 109, Accounting for Income Taxes
- FASB Interpretation No. 18, Accounting for Income Taxes in Interim Periods...an interpretation of APB Opinion No. 28
- Accounting Principles Board Opinion No. 2, Accounting for the “Investment Credit”
- Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the “Investment Credit”
- Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966
- Accounting Principles Board Opinion No. 23, Accounting for Income Taxes—Special Areas—Accounting Principles Board Opinion No. 28, Interim Financial Reporting
- FASB Technical Bulletin No. 79-9, Accounting for Interim Periods for Changes in Income Tax Rates
- FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases
- FASB Emerging Issues Task Force No. 91-8, Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax
- FASB Emerging Issues Task Force No. 92-8, Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary
- FASB Emerging Issues Task Force No. 93-13, Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations
- FASB Emerging Issues Task Force No. 93-16, Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23
- FASB Emerging Issues Task Force No. 93-17, Recognition of Deferred Tax Assets for a Parent Company’s Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation
- FASB Emerging Issues Task Force No. 94-10, Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109
- FASB Emerging Issues Task Force No. 95-9, Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109
- FASB Emerging Issues Task Force No. 95-10, Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109
- FASB Emerging Issues Task Force No. 95-20, 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
- AICPA Accounting Interpretation, Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4

Other Sources of Information
- Federal Income Tax Regulation Section 1.6662-4(d)
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Statutory Issue Paper No. 84

Quasi-Reorganizations

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Readjustments of additional paid in capital as if a reporting entity were reorganized but without the occurrence of a formal reorganization are considered to be quasi-reorganizations. Generally, quasi-reorganizations result in the elimination of a deficit retained earnings and establishment of a new basis for assets and liabilities. Current statutory accounting guidance does not address quasi-reorganizations.

2. GAAP addresses accounting for quasi-reorganizations in Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins (ARB 43) and in Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus (ARB 46). Guidance is also provided in the Securities and Exchange Commission Codification of Financial Reporting Policies, Section 210 and in the Staff Accounting Bulletins--Codification.

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

SUMMARY CONCLUSION

4. Restatement of gross paid in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization shall be permitted only if the criteria in both subparagraphs 4 a and 4 b and either subparagraph 4 c or 4 d are met:

   a. Such restatement is approved in writing by the domiciliary Commissioner;

   b. An 80% or greater change in the ultimate ownership of the reporting entity has occurred within six months prior to approval of such restatement;

   c. A new business plan has been adopted that results in a substantive change in the operations and business mix of the reporting entity and the situation or circumstances that gave rise to the negative unassigned funds (surplus) will not be part of the ongoing operations;

   d. The reporting entity is a shell company with no existing operations, inforce policies or outstanding claims.

5. As defined in Issue Paper No. 72—Statutory Surplus, unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. In no instance shall restatement result in the unassigned funds (surplus) account being greater than zero or the gross paid in and contributed surplus account being less than zero immediately following the restatement. Total surplus as regards policyholders shall remain unchanged following such restatement. The following components of unassigned funds (surplus) shall be considered in determining the amount available for restatement:
6. The assets and liabilities of the reporting entity shall continue to be carried at historical cost or other value required under statutory accounting principles. No adjustments to assets or liabilities shall be made to reflect the effect of a quasi-reorganization.

7. The impact of the restatement shall be disclosed in the notes to financial statements as long as financial statements for the period of the reorganization are presented. The effective date of the reorganization shall be disclosed for a period of ten years following the reorganization.

DISCUSSION

8. Current statutory accounting guidance does not address quasi-reorganizations. Quasi-reorganization is a concept in GAAP that is intended to apply in very limited situations. The effect in GAAP accounting for a quasi-reorganization is to eliminate negative retained earnings by capitalizing negative retained earnings to paid-in capital; and, to adjust net assets downward, but not upward, to fair value (i.e., individual assets may be written up or liabilities reduced as appropriate, but only to the extent that the aggregate net adjustment does not increase net assets). Quasi-reorganizations are initiated for various purposes, including to facilitate the payment of dividends by a reporting entity that is currently profitable but has negative retained earnings prior to the quasi-reorganization.

9. The conclusion permits the restatement of gross paid in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization in certain limited circumstances. The conclusion also requires that total surplus as regards policyholders remain unchanged following such restatement and that the assets and liabilities of the reporting entity be carried at historical cost or other value required under statutory accounting principles and not revalued pursuant to a quasi-reorganization. This conclusion allows regulatory flexibility in instances where there has been a change in the ultimate ownership, the business plan of the reporting entity has substantively changed the operations and business mix of the reporting entity and the situation or circumstances that gave rise to the negative unassigned funds (surplus) will not be part of the ongoing operations, or the reporting entity is a shell company with no existing operations or outstanding policies. This conclusion is consistent with the regulatory need for consistent data on a year-to-year basis in order to monitor performance of insurance enterprises on a continuing basis. The conclusion is also consistent with the requirement to retain the historical basis of reporting following a business combination as discussed in Issue Paper No. 68—Business Combinations and Goodwill.

10. This issue paper adopts Chapter 7, Section A of ARB 43 with a modification to permit restatement of gross paid in and contributed surplus and unassigned funds (surplus) only in certain limited circumstances. In addition, this issue paper requires that the assets and liabilities of the reporting entity continue to be carried at historical cost or other value required under statutory accounting principles and that no changes to total surplus as regards policyholders are to be made to reflect the effect of a quasi-reorganization. This issue paper adopts ARB 46 with modification to require disclosure of the impact of the restatement in the notes to financial statements as long as financial statements for the period of reorganization are presented.
11. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts, as follows:

**Conservatism**

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

**Consistency**

The regulators’ need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

**Drafting Notes/Comments**

None

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

None

**Generally Accepted Accounting Principles**

12. ARB 43 provides the following guidance (only the pertinent excerpts are included below):

Chapter 7: CAPITAL ACCOUNTS
Section A -- Quasi-Reorganization or Corporate Readjustment

(Amplification of Institute Rule No. 2 of 1934)

1. A rule was adopted by the Institute in 1934 which read as follows:

“Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.”

1 See chapter 1A, paragraph 2.

2. Readjustments of the kind mentioned in the exception to the rule fall in the category of what are called quasi-reorganizations. This section does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases are referred
to as readjustments. The problems which arise fall into two groups: (a) what may be permitted in a readjustment and (b) what may be permitted thereafter.

Procedure in Readjustment

3. If a corporation elects to restate its assets, capital stock, and surplus through a readjustment and thus avail itself of permission to relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst, it should make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair balance sheet as at the date of the readjustment, in which the adjustment of carrying amounts is reasonably complete, in order that there may be no continuation of the circumstances which justify charges to capital surplus.

4. A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount should be described as an estimate and any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date should not be carried to income or earned surplus.

5. Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, provision may properly be made to cover the maximum probable losses or charges. If the amounts provided are subsequently found to have been excessive or insufficient, the difference should not be carried to earned surplus nor used to offset losses or gains originating after the readjustment, but should be carried to capital surplus.

6. When the amounts to be written off in a readjustment have been determined, they should be charged first against earned surplus to the full extent of such surplus; any balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus survives a readjustment in which any part of losses has been charged to capital surplus.

7. If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company’s interest in such earned surplus should be regarded as capitalized by the readjustment just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

8. The effective date of the readjustment, from which the income of the company is thereafter determined, should be as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year.

Procedure after Readjustment

9. When the readjustment has been completed, the company’s accounting should be substantially similar to that appropriate for a new company.

10. After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.
11. Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it should be only those which may properly be made against the initial surplus of a new corporation.

12. It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past. In this statement the committee has dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made thereagainst.

13. ARB 46 provides the following guidance (only the pertinent excerpts are included below):

1. Paragraph 10 of Chapter 7(a), Quasi-Reorganization or Corporate Readjustment, of Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, reads as follows:

   After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

2. The committee believes that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. It also believes that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years.

OTHER SOURCES OF INFORMATION

14. Securities and Exchange Commission Codification of Financial Reporting Policies, Section 210 provides the following guidance (only the pertinent excerpts are included below):

210 Quasi-Reorganization ASR 25:
Inquiry has been made from time to time as to the conditions under which a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without the creation of new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization.
It has been the Commission’s view for some time that a quasi-reorganization may not be considered to have been effected unless at least all of the following conditions exist:

1. Earned surplus, as of the date selected, is exhausted;
2. Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;
3. The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions;
4. The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

It is implicit in such a procedure that reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relatively permanent reductions in asset values; as for example, complete or partial obsolescence, lessened utility value, reduction in investment value due to changed economic conditions, or, in the case of current assets, declines in indicated realization value. It is also implicit in a procedure of this kind that it is not to be employed recurrently but only
under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole or principal purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses. In the case of the quasi-reorganization of a parent company, it is an implicit result of such procedure that the effective date should be recognized as having the significance of a date of acquisition of control of subsidiaries. Likewise, in consolidated statements, earned surplus of subsidiaries at the effective date should be excluded from earned surplus on the consolidated balance sheet.

15. The Securities and Exchange Commission Staff Accounting Bulletins--Codification provides the following guidance (only the pertinent excerpts are included below):

S. Quasi-Reorganization

Facts:

As a consequence of significant operating losses and/or recent write-downs of property, plant and equipment, a company’s financial statements reflect an accumulated deficit. The company desires to eliminate the deficit by reclassifying amounts from paid-in-capital. In addition, the company anticipates adopting a discretionary change in accounting principles\(^1\) that will be recorded as a cumulative-effect type of accounting change. The recording of the cumulative effect will have the result of increasing the company’s retained earnings.

\(^1\) Discretionary accounting changes require the filing of a preferability letter by the registrant’s independent accountant pursuant to Item 601 of Regulation S-K and Rule 10-01(b)(6) of Regulation S-X, 17 CFR §§229.601 and 210.10-01(b)(6), respectively.

Question 1:

May the company reclassify its capital accounts to eliminate the accumulated deficit without satisfying all of the conditions enumerated in Section 210\(^2\) of the Codification of Financial Reporting Policies for a quasi-reorganization?

\(^2\) Accounting Series Release No. 25 (May 29, 1941).
Interpretive Response:

No. The staff believes a deficit reclassification of any nature is considered to be a quasi-reorganization. As such, a company may not reclassify or eliminate a deficit in retained earnings unless all requisite conditions set forth in Section 210\(^3\) for a quasi-reorganization are satisfied.\(^4\)

\(^3\) Section 210 indicates the following conditions under which a quasi-reorganization can be effected without the creation of a new corporate entity and without the intervention of formal court proceedings:

1. Earned surplus, as of the date selected, is exhausted;
2. Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;
3. The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable laws and charter provisions;
4. The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

\(^4\) In addition, Accounting Research Bulletin (ARB) No. 43, Chapter 7A, outlines procedures that must be followed in connection with and after a quasi-reorganization.

Question 2:

Must the company implement the discretionary change in accounting principle simultaneously with the quasi-reorganization or may it adopt the change after the quasi-reorganization has been effected?

Interpretive Response:

The staff has taken the position that the company should adopt the anticipated accounting change prior to or as an integral part of the quasi-reorganization. Any such accounting change should be effected by following generally accepted accounting principles with respect to the change.\(^5\)

\(^5\) Accounting Principles Board Opinion No. 20 provides accounting principles to be followed when adopting accounting changes. In addition, many newly-issued accounting pronouncements provide specific guidance to be followed when adopting the accounting specified in such pronouncements.

Chapter 7A of Accounting Research Bulletin (ARB) No. 43 indicates that, following a quasi-reorganization, a “company’s accounting should be substantially similar to that appropriate for a new company.” The staff believes that implicit in this “fresh-start” concept is the need for the company’s accounting principles in place at the time of the quasi-reorganization to be those planned to be used following the reorganization to avoid a misstatement of earnings and retained earnings after the reorganization.\(^6\) Chapter 7A of ARB No. 43 states, in part, “… in general, assets should be carried forward as of the date of the readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the Company thereafter (emphasis added).”

\(^6\) Certain newly-issued accounting standards do not require adoption until some future date. The staff believes, however, that if the registrant intends or is required to adopt those standards within 12 months following the quasi-reorganization, the registrant should adopt those standards prior to or as an integral part of the quasi-reorganization. Further, registrants should consider early adoption of standards with effective dates more than 12 months subsequent to a quasi-reorganization.
In addition, the staff believes that adopting a discretionary change in accounting principle that will be reflected in the financial statements within 12 months following the consummation of a quasi-reorganization leads to a presumption that the accounting change was contemplated at the time of the quasi-reorganization.\footnote{Certain accounting changes require restatement of prior financial statements. The staff believes that if a quasi-reorganization had been recorded in a restated period, the effects of the accounting change on quasi-reorganization adjustments should also be restated to properly reflect the quasi-reorganization in the restated financial statements.}

\footnote{7 Certain accounting changes require restatement of prior financial statements. The staff believes that if a quasi-reorganization had been recorded in a restated period, the effects of the accounting change on quasi-reorganization adjustments should also be restated to properly reflect the quasi-reorganization in the restated financial statements.}

Question 3:

In connection with a quasi-reorganization, may there be a write-up of net assets?

Interpretive Response:

No. The staff believes that increases in the recorded values of specific assets (or reductions in liabilities) to fair value are appropriate providing such adjustments are factually supportable, however, the amount of such increases are limited to offsetting adjustments to reflect decreases in other assets (or increases in liabilities) to reflect their new fair value. In other words, a quasi-reorganization should not result in a write-up of net assets of the registrant. (Added by SAB No. 78, 8/25/88.)

Question 4:

The interpretive response to question 1 indicates that the staff believes that a deficit reclassification of any nature is considered to be a quasi-reorganization, and accordingly, must satisfy all the conditions of Section 210.\footnote{Supra Note 3.}

\footnote{8 Supra Note 3.}

Assume a company has adopted Statement of Financial Accounting Standards (“SFAS”) No. 96, has satisfied all the requisite conditions of Section 210, and has eliminated a deficit in retained earnings by a concurrent reduction in paid-in capital, but did not need to restate assets and liabilities by a charge to capital because assets and liabilities were already stated as fair values. How should the company reflect the tax benefits of operating loss or tax credit carryforwards for financial reporting purposes that existed as of the date of the quasi-reorganization when such tax benefits are subsequently recognized for financial reporting purposes?
Interpretive Response:

The staff believes SFAS No. 96 requires that any subsequently recognized tax benefits of operating loss or tax credit carryforwards that existed as of the date of a quasi-reorganization be reported as a direct addition to paid-in capital. The staff believes that this position is consistent with the “new company” or “fresh-start” concept embodied in Section 210, and in existing accounting literature regarding quasi-reorganizations, and with the FASB staff’s justification for such a position when they stated that a “new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date.

Section 210 discusses the “conditions under which a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without creation of new corporate entity and without intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization.” It further indicates that “it is implicit in a procedure of this kind that it is not to be employed recurrently but only under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses.”

The FASB recognized that a practice existed of recording deficit elimination type quasi-reorganizations without evaluating the concurrent need to restate assets and liabilities to fair values, and provided guidance on accounting for the tax benefits of carryforward items subsequent to such an event. This practice and accounting is not permitted by Section 210, and accordingly, is not appropriate for registrants. The staff believes that all registrants that comply with the requirements of Section 210 in effecting a quasi-reorganization should apply the accounting required by the first sentence of paragraph 54 of SFAS No. 96 for the tax benefits of tax carryforward items. Therefore, even though the only effect of a quasi-reorganization is the elimination of a deficit in retained earnings because assets and liabilities are already stated at fair values and the revaluation of assets and liabilities is unnecessary (or a write up of net assets is prohibited as indicated in the interpretive response to question 3 above), subsequently recognized tax benefits of operating loss or tax credit carryforward items should be recorded as a direct addition to paid-in capital.

SFAS No. 96 (December 1987); paragraph 54, states: “Some quasi reorganization involve only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital. For that type of reorganization, subsequent recognition of the tax benefit of a prior operating loss or tax credit carryforward for financial reporting is reported as required by paragraph 52 and then reclassified from retained earnings to contributed capital.”

The first sentence or paragraph 54 of SFAS No. 96 states: “The tax benefit of an operating loss or tax credit carryforward for financial reporting as of the date of a quasi-reorganization as defined and contemplated (involving write-offs directly to contributed capital) in ARB No. 43, Chapter 7, “Capital Accounts,” is reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years.”
Question 5:

If a company had previously recorded a quasi-reorganization that only resulted in the elimination of a deficit in retained earnings, may the company reverse such entry and "undo" its quasi-reorganization?

Interpretive Response:

No. The staff believes APB Opinion No. 20 would preclude such a change in accounting. It states: "a method of accounting that was previously adopted for a type of transaction or event which is being terminated or which was a single, nonrecurring event in the past should not be changed." [Emphasis added.]\(^\text{13}\)

\(^{13}\) Accounting Principles Board Opinion No. 20 (July 1971); paragraph 16.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 68—Business Combinations and Goodwill
- Issue Paper No. 72—Statutory Surplus

Generally Accepted Accounting Principles
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 7, Section A, Quasi-reorganization or Corporate Readjustment
- Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus

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

Other Sources of Information
- Securities and Exchange Commission Codification of Financial Reporting Policies, Section 210
- Securities and Exchange Commission Staff Accounting Bulletins - Codification, Topic 5, S
Statutory Issue Paper No. 85

Derivative Instruments

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Chapter 8 of the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) contains guidance on accounting for derivative instruments. This guidance provides two alternatives for accounting for derivative instruments: (a) Hedge accounting, or (b) Immediate recognition (mark to market) accounting. Specific accounting guidance for Income Generation Transactions was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996.

2. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. To the extent that specific accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. The key GAAP accounting literature applicable to derivatives, which is primarily addressed in FASB Statement No. 80, Accounting for Futures Contracts (FAS 80), FASB Statement No. 52, Foreign Currency Translation (FAS 52), and FASB Emerging Issues Task Force Issue No. 84-36, Interest Rate Swap Transactions (EITF 84-36), is based on hedge accounting for futures and foreign exchange contracts, settlement accounting for interest rate swaps and mark to market accounting.

3. The purpose of this issue paper is to establish statutory accounting principles for derivative instruments (hereinafter referred to as derivatives), that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper adopts the Derivative Instruments guidance of Chapter 8 of the Life/A&H and P&C Accounting Practices and Procedures Manuals. Paragraphs 6 through 10 herein summarize the key provisions of the guidance. Derivatives shall be defined as swaps, options, forwards, futures, caps, floors, and collars. The following are general definitions for these derivative instruments:

   a. Swaps: Swaps are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;

   b. Options: Options are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;
c. Forwards: Forward contracts are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;

d. Futures: Futures are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;

e. Caps: Caps are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;

f. Floors: Floors are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

g. Collars: A collar is a combination of a cap and a floor (one purchased and one written). A collar fixes the rate between two levels (the strike prices of the cap and the floor).

5. To the extent a derivative is in an asset position, the instrument meets the definition of an asset as defined in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets and, subject to certain limitations, meets the criteria for an admitted asset as specified in that same paper. To the extent a derivative is in a liability position, the instrument meets the definition of a liability as defined in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No 5).

6. Hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce: (a) the risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities which the reporting entity has acquired or incurred or anticipates acquiring or incurring, or (b) the currency exchange rate risk or the degree of exposure as to assets or liabilities which a reporting entity has acquired or incurred or anticipates acquiring or incurring. Derivatives used by reporting entities in hedging activities shall be accounted for in a manner consistent with the item hedged. For example, if the item being hedged is accounted for at amortized cost, the hedging derivative also is accounted for at amortized cost. If the item being hedged is accounted for at market value, the hedging derivative also is accounted for at market value.

7. To qualify for hedge accounting, the derivative shall be designated as a hedge of a specific asset, liability, or anticipated transaction. The specific asset, liability, or anticipated transaction to be hedged must expose the reporting entity to a risk and the designated derivative transaction must reduce that exposure. Examples of items that expose the reporting entity to risk include change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities, or future cash
flows which a reporting entity has acquired or incurred, or anticipates acquiring or incurring. To satisfy the condition of risk reduction, the reporting entity shall demonstrate how the derivative instrument reduces risk by using an appropriate method. There are a variety of methods available that can be used to demonstrate risk reduction, including methods which analyze the correlation of gains and losses on the derivative in relation to the losses and gains on the hedged asset, liability, or future cash flow. Included in the concept of hedge accounting is the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue.

8. Reporting entities shall set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and apply those criteria in the ongoing assessment of actual hedge results. For example, if correlation is used to measure the effectiveness of a hedge, high correlation of changes in the fair value of the derivative and the fair value of the item being hedged should be probable so that such changes will substantially offset each other throughout the hedge period. Other methods used should demonstrate a similar result to be considered effective. Also, at the inception of the hedge, formal documentation of the hedging instrument and the related hedged item, including the nature of the risk being hedged, shall be drafted and retained for future reference. Upon termination of the derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item. If the item being hedged is subject to IMR, the gain or loss on the hedging derivative instrument shall be subject to IMR upon termination. Reporting entities shall account for a derivative at estimated fair value if it ceases to be effective as a hedge (that is, the gains and losses on the derivative no longer offset the losses and gains on the hedged instrument) and recognize the gain or loss currently in earnings.

9. Alternatively, reporting entities may mark derivatives to market (immediate recognition method) from inception to termination. Generally, this alternative is used where it is impractical to allocate gains and losses to specific hedged assets, liabilities, or future cash flows. This alternative shall be used for derivatives that are entered into for other than hedging purposes, when a portfolio has been hedged and the reporting entity is unable to assign the hedging instrument to specific assets and liabilities, or for derivatives that are not specifically addressed elsewhere in this guidance.

10. Other than hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. Unrealized gains and losses cannot be deferred when categorized as other than hedging.

11. The reporting entity’s choice between accounting methods discussed in paragraphs 6 through 9 (hedge versus immediate recognition) shall be applied consistently for each individual instrument over the life of the derivative. A change in method shall be justified by a significant change in circumstance.

Income Generation Transactions

12. Income generation transactions are defined as derivative instruments written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock which it already owns).

13. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be “covered” (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.
14. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

15. The principal features of income generation transactions are:
   a. Premium received is initially recorded as a deferred liability;
   b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., bonds);
   c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;
   d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

16. The principal features of written fixed income covered call options are:
   a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract;
   b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;
   c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;
   d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset’s book value, the asset shall be evaluated for write down or disclosure treatment in accordance with Issue Paper No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income shall be considered.
17. Written fixed income covered call options shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)</td>
<td></td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
</tbody>
</table>

Notes:

1. A general statement will be added to the instructions stating that reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.


3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.
18. The principal features of written covered put options are:

a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;

b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;

c. As with covered call writing, reporting entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy;

19. Written covered put options shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>UNDERLYING INTEREST VALUED AT AMORTIZED COST</th>
<th>UNDERLYING INTEREST VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust acquisition cost by premium received.</td>
<td>Adjust acquisition cost by premium received.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

Notes:

1. Reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.
20. The principal features of written fixed income caps and floors are:

   a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the reporting entity is selling off possible excess interest/income, the value of the covering asset is not relevant;

   b. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract’s maturity.

21. Written fixed income caps and floors shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value. (Alternatively carry at consideration received if within 1 year of maturity.)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Amortize over life of contract to produce constant yield.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Record any interest expense as “Other Investment Income” – negative value.</td>
<td></td>
</tr>
<tr>
<td>Closed – Matured</td>
<td>Would usually mature at zero amortized value.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Not applicable.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain/loss on termination to flow through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

22. Examples of accounting and presentation based on varying assumptions can be found in the October 1, 1996 minutes of the Accounting Practices and Procedures (EX4) Task Force.

**Disclosure Requirements**

23. Reporting entities shall disclose the following for all derivative contracts outstanding:

   a. Disclosures by category of instrument:

   i. Notional or contract amounts;
   ii. Carrying and fair values;
   iii. A description of the accounting policies for derivatives;
iv. A discussion of the market risk, credit risk, and cash requirements of the derivative instruments.

b. General Disclosures:

i. A description of the reporting entity’s objectives for holding or issuing the derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivatives used;

ii. A description of how each category of derivative is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives held or issued, and when recognized, where those instruments and related gains and losses are reported.

24. Reporting entities shall disclose the following for derivatives held for other than hedging purposes:

a. Average fair value of the derivative instruments during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;

b. Net gains or losses disaggregated by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.

25. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

DISCUSSION

26. The Summary Conclusion adopts the aforementioned sections of current statutory accounting principles (Chapter 8) for derivatives including insurance futures and insurance futures options. These principles are consistent with the Statement of Concepts because they provide recognition of derivatives as assets or liabilities, and recognition of income (gains) or expense (losses) based on how the reporting entity uses the derivative to reduce risk related to an existing exposure. It also provides a consistent approach to accounting for the many types of derivatives currently available to reporting entities.

27. This issue paper clarifies that the immediate recognition method of accounting (mark to market) shall be applied in situations where a reporting entity enters into a derivative for other than hedging purposes, when a portfolio has been hedged, or for derivatives that are not specifically addressed elsewhere in this guidance. Other than hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. This clarification is added so that unrealized gains and losses, particularly losses, cannot be deferred when categorized as other than hedging. This is consistent with the conservatism concept in the Statement of Concepts. Further, the immediate recognition method of accounting is not precluded from being utilized in situations where the derivative qualifies for hedge accounting.

28. This issue paper also provides that the determination of hedge accounting or immediate recognition accounting shall be made for each individual instrument. A reporting entity may utilize immediate recognition accounting for certain derivatives within a category and hedge accounting for other derivatives within that same category. This is a change from current statutory accounting principles, which provide that the categories to which immediate recognition accounting treatment is applied should be consistent from period to period.
29. While there is a separate section in the current statutory accounting guidance for insurance futures and related instruments, the accounting is similar to that of other derivatives. Therefore, the conclusion does not differentiate futures or options accounting from insurance futures or insurance futures options accounting, however, the distinctions in current statutory guidance in accounting and reporting for these instruments are adopted. The separate section for insurance futures and insurance futures options was incorporated into the current Life/A&H and P&C Accounting Practices & Procedures Manuals because insurance futures are viewed by insurance regulators as insurance-related transactions and not as investment-related transactions. As a result, insurance futures and insurance futures options are reported on Schedule DC and not Schedule DB as for other non-insurance derivatives. Also, income related to insurance futures and insurance futures options is reported as an aggregate write-in for miscellaneous income not as investment income and any asset is recorded as an aggregate write-in for other than invested assets.

30. Current statutory accounting does not specifically address settlement accounting for interest rate swaps. Under certain conditions (as set forth in EITF Issue No. 84-36), GAAP permits settlement accounting for interest rate swaps. Therefore, EITF Issue Nos. 84-36 and 84-7 are adopted.

31. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue. Settlement accounting is considered a conservative approach, and in many instances, produces an accounting result which is similar to hedge accounting. Such accounting is widely accepted in practice and provides an accounting approach that is consistent with the purpose of entering into such an instrument; that is, to change the interest rate characteristics of the balance sheet item to which it is matched. When this issue paper refers to hedge accounting, it encompasses the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet.

32. The accounting and reporting for derivative instruments used for income generation is intended to meet (1) regulatory needs focusing on company and industry solvency, (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

   a. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset;

   b. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the NAIC Accounting Practices and Procedures Manual and in the Annual Statement Instructions regarding hedging;

   c. The approach looks to the substance of the transactions involved:

      i. It matches the accounting of the derivative with the accounting of the covering asset or underlying interest;

      ii. It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces;

      iii. It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.
33. Under GAAP, although there is no authoritative accounting guidance for written covered options, written options are generally reported at fair value with changes in fair value reported in earnings because written options do not qualify for hedge accounting except to the extent of the premium received. However, certain GAAP practice considers that the writer will never sustain a loss on a written covered option if the strike price of the option exceeds the book value of the covered asset, and the writer intends to deliver the covered asset if the option is exercised instead of settling the option in cash. Under these circumstances, certain GAAP practice includes carrying the option at cost with the option premium recorded in income when the options is exercised, at its expiration, or, if designated as a hedge, deferred as an adjustment of the cost of the covered asset.

34. Based on the inconsistency in the accounting results and the uncertainty surrounding the GAAP accounting for derivatives, other GAAP pronouncements are rejected as discussed below. Although some view GAAP accounting for derivatives as more conservative because of the stricter requirements of hedge accounting, statutory requirements are sufficiently restricted so that they are consistent with the conservatism and recognition principles of the Statement of Concepts.

35. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. Under GAAP, there are different rules for different derivatives and there are different rules for different uses of derivatives. To the extent that specific GAAP accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. Also, the accounting for futures, forwards, options and swaps differs depending on whether these instruments are denominated in a domestic currency or in a foreign currency. The guidance in FAS 80 is used for futures contracts, and, by analogy, for certain other derivatives when they are denominated in the domestic currency of the entity. Although certain of the notions of designation, risk reduction and correlation from FAS 80 are incorporated in this paper, FAS 80 is rejected since statutory accounting principles as clarified herein provide sufficient guidance for hedge accounting. Consistent with Issue Paper No. 81—Foreign Currency Transactions and Translations, FAS 52 is rejected for reasons set forth in that paper. However, some of the elements of FAS 52 have been incorporated into this paper. The guidance in FAS 52 generally is applied when these instruments are denominated in a foreign currency that is not the functional currency of the entity. Also, this issue paper rejects the following GAAP pronouncements, which are limited to very narrow situations for which the broad accounting described in this issue paper is sufficient (such pronouncements are not reproduced herein due to length and limited scope):

- FASB Emerging Issues Task Force No. 84-14, Deferred Interest Rate Setting
- FASB Emerging Issues Task Force Issue No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions
- FASB Emerging Issues Task Force Issue No. 87-2, New Present Value Method of Valuing Speculative Foreign Exchange Contracts
- FASB Emerging Issues Task Force Issue No. 88-8, Mortgage Swaps
- FASB Emerging Issues Task Force Issue No. 90-17, Hedging Foreign Currency Risk with Purchased Options
- FASB Emerging Issues Task Force Issue No. 91-1, Hedging Intercompany Foreign Currency Risks
- FASB Emerging Issues Task Force Issue No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions
- FASB Emerging Issues Task Force Issue No. 95-11, Accounting for Derivative Instruments Containing both a Written Option-Based Component and a Forward-Based Component
- FASB Emerging Issues Task Force Issue No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115
36. Because of inconsistencies in the accounting for derivatives, the FASB has been involved in a long-term project to address the accounting for off-balance-sheet financial instruments and is currently involved in deliberations to change the current accounting for derivatives under GAAP.

Disclosure Requirements
37. The disclosures required by FAS 105 cover financial instruments with off-balance-sheet risk of accounting loss. The scope includes derivatives with off-balance sheet risk as well as other types of financial instruments. FAS 105 is adopted for all financial instruments with off-balance-sheet risk with the following modifications:

   a. The disclosures required in paragraph 17 shall distinguish between derivatives entered into for hedging purposes and for other than hedging purposes;

   b. Paragraph 19 is rejected. It addresses voluntary disclosures not required by this issue paper.

38. FAS 119 extends the requirements of FAS 105 to all derivatives and requires additional disclosures. FAS 119 is adopted with the following modifications:

   a. The disclosures required in paragraph 8 shall distinguish between derivatives entered into for hedging purposes and for other than hedging purposes;

   b. The disclosures required for trading derivatives by paragraph 10 shall be required for derivatives entered into for other than hedging purposes;

   c. Only the required disclosures in FAS 119 are adopted by this issue paper not the voluntary quantitative or qualitative disclosures. Therefore, paragraphs 12 and 13 are rejected.

39. Current statutory guidance provides specific information relating to derivatives in Schedules DB and DC of the Annual Statement. GAAP requires disclosures about derivative financial instruments in accordance with FAS 119. FAS 119 requires a distinction between derivatives used for trading and other than trading purposes for purposes of disclosure in the notes to the financial statements. Other information is required in the notes, such as notional amounts, carrying and fair values by category of derivative, a description of the accounting policies for derivatives, market and credit risk as well as other optional quantitative and qualitative information. Most of the required disclosures can be derived from information provided on Schedules DB and DC of the Annual Statement. The disclosure requirements are not intended to provide duplicative presentation in the annual statement filings but are required in those circumstances where the accompanying exhibits which contain certain required disclosures are not part of the reporting entity’s financial statements (e.g., annual audit report). The disclosures required by FAS 119 are modified in that the classification of the disclosures shall be based on the accounting methodology adopted for the instrument based on hedge accounting or immediate recognition accounting, rather than on the notions of trading and other than trading in FAS 119.

Drafting Notes
- The accounting for investments in mortgage backed securities, collateralized mortgage obligations, real estate mortgage investment conduits, interest-only securities and principal-only securities, among others, is primarily addressed in Issue Paper No. 43—Loan-Backed and Structured Securities.

- The Invested Asset Working Group of the Valuation of Securities (EX4) Task Force met on June 2, 1996 and considered four derivatives projects. In October of 1996, the Blanks Task Force will consider incorporation of certain changes to current derivatives guidance, a summary of which is provided in paragraph 49.
RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

40. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contains the following guidance relating to derivative instruments:

**Derivative Instruments**

Derivative instruments are reported in Schedule DB of the annual statement using the definitions below. Specific accounting procedures for each derivative instrument will depend on the definition below that best describes the instrument. State investment laws and regulations should be consulted for applicable limitations on the use of derivative instruments.

Definitions:

"Underlying Interest" means the asset(s), liability(ies) or other interest(s) underlying a Derivative Instrument, including, but not limited to, any one or more securities, currencies, rates, indices, commodities, Derivative Instruments or other financial market instruments.

"Option" means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price level, performance or value of, one or more Underlying Interests.

"Cap" means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a reference price, level, performance or value of one or more Underlying Interests exceeds a predetermined number, sometimes called the strike/cap rate or price.

"Floor" means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a predetermined number, sometimes called the strike/floor rate or price, exceeds a reference price, level, performance or value of one or more Underlying Interests.

"Collar" means an agreement to receive payments as the buyer of an Option, Cap or Floor and to make payments as the seller of a different Option, Cap or Floor.

"Swap" means an agreement to exchange or net payments at one or more times based on the actual or expected price, level, performance or value of one or more Underlying Interests.

"Forward" means an agreement (other than a Futures) to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.

"Futures" means an agreement traded on an exchange, board of trade or contract market, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.

**General Accounting Guidance:**

**Hedging:**

Derivative instruments used by insurers in hedging transactions should be accounted for in a manner consistent with the item hedged prior to termination. Upon termination, the gains and losses from the derivative instrument will adjust the basis of the hedged item.
Alternatively, companies may mark derivative instruments of a given type to market from inception to termination with gains and losses recognized currently. Generally this alternative is used where it is impractical to allocate gains and losses to specific hedged assets or liabilities. The accounting treatment and categories to which this accounting treatment is applied should be consistent from period to period. However, derivative instruments hedging items which are subject to IMR will follow hedge accounting (amortized book value) while the instruments are still open and that the gains/losses will be subject to IMR upon termination.

For a derivative instrument to qualify for hedge accounting, the item to be hedged must expose the company to a risk and the designated derivative transaction must reduce that exposure. Examples include the risk of a change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities or future cash flows which an insurer has acquired or incurred, or anticipates acquiring or incurring.

A company should set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and then apply those criteria in the ongoing assessment based on actual hedge results. Insurers should account for a derivative instrument at market value if it ceases to be “effective” as a hedge and recognize the gain or loss currently to the extent it has not been offset by the effects of changes on the hedged item.

Documentation Guidance:

An insurer shall maintain documentation and records relating to derivative instruments opened during the year, instruments outstanding at year end, and instruments terminated during the year. Minimum required documentation is as follows:

(a) For derivative instruments opened during the year:

(1) A description, for each instrument, of the purpose of the transaction, including:

• A brief description of the assets and/or liabilities hedged by the instrument.
• A brief description of the manner in which the instrument reduces risk.
• A reference to the company’s hedge program under which such transaction is internally authorized.

(2) Signature of approval, for each instrument, by person(s) authorized, either by the insurer’s board of directors or a committee authorized by the board, to approve such transactions.

(3) A description, for each instrument, of the nature of the transaction, including:

• The date of the transaction.
• A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
• Number of contracts or notional amount.
• Date of maturity, expiry or settlement.
• Strike price, rate or index, (opening price for futures contracts).
• Counterparty, or exchange on which the transaction was traded.
• Cost or consideration received, if any, for opening transaction.
(4) A description of the company methodology used to verify that opening transactions do not exceed limitations promulgated by the insurers state of domicile.

(b) For derivative instruments terminated during the year:

(1) Signature of approval, for each instrument, by person(s) authorized, either by the insurer's board of directors or a committee authorized by the board, to approve such transactions.

(2) A description, for each instrument, of the nature of the transaction, including:

- The date of the transaction.
- A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
- Number of contracts or notional amount.
- Date of maturity, expiry or settlement.
- Strike price, rate or index, (termination price for futures contracts).
- Counterparty, or exchange on which the transaction was traded.
- Consideration paid or received, if any, on termination.

(3) Description of company methodology to verify that derivative instruments were effective hedges.

(4) Identification of any derivative instruments that ceased to be effective as hedges.

(c) For derivative instruments open at year end:

(1) A description of the methodology used to verify the continued effectiveness of hedges.

(2) An identification of any derivative instruments which have ceased to be effective as hedges.

(3) A description of company methodology to determine market values of derivative instruments.

(4) Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Specific Accounting Procedures for Derivative Instruments

(a) Call and Put Options, Caps, and Floors:

(1) Accounting at Date of Acquisition (purchase) or Issuance (written):

The premium paid or received for purchasing or writing a call option, put option, cap or floor shall be carried as an asset (purchase) or liability (written) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).
(2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where company does not elect to recognize gain/loss currently):
  
  - Options, caps and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item.
  
  - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities, the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
    
    - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
    
    - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
    
    - For other derivative instruments, the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
    
    - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
    
    - If during the life of the derivative instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent they ceased to be effective hedges.
    
    - Open derivative instruments hedging items carried at market value, (where company does not elect to recognize gain/loss currently):
      
      - Options, caps or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.
      
      - Usually this will result in unrealized gain/loss treatment with adjustment to surplus.
• For hedges where the cost of the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.

• Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

• For hedges of items which are not subject to IMR, options, caps or floors purchased or written shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.

• For hedges of items which are subject to IMR, options, caps and floors purchased or written shall be valued at amortized cost as in (2)(a) above.

(3) Cash Flows and Income:

• Where the cost of the derivative instrument is not combined with the hedged item:

  • Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2;

  • Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.

• Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.

(4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):

• Exercise of an Option: The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.

• Sale, maturity, expiry, or other closing transaction of a derivative instrument which is an effective hedge — Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.
• Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

• Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on derivative instruments acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.

• For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

(b) Swaps, Collars and Forwards:

An interest rate swap is a contractual agreement between two parties to exchange interest rate payments (usually fixed for variable) based on a specified amount of underlying assets or liabilities (known as the notional amount) for a specified period. The swap does not involve an exchange of principal. The result of these transactions is to transform payments from a variable rate to a fixed rate, from a fixed rate to a variable rate or from one variable rate index to another variable rate index.

Interest rate swaps have historically been entered into for the purpose of lowering borrowing costs, obtaining otherwise unavailable financing terms, and/or improving asset and liability management through a reduction of an entity’s exposure to interest rate risk. Banks and brokers will enter into an interest rate swap with an interested party before a swap partner is found, creating a swap portfolio. This activity allows the corporation that desires a swap transaction immediate access to the market. This secondary market also allows a swap participant a vehicle to unwind or reverse swap positions it no longer wants or receive cash if the position to be disposed of is favorable in relation to the current market.

While swaps may involve the trading of interest on liabilities or assets, insurance industry members have used swaps to match return on assets to contract obligations. Insurers also have acted as an intermediary or broker in the process of arranging a swap. Swaps may involve long periods of time and significant amounts of interest on substantial notional amounts. Unmatched or naked swaps are sometimes written where no underlying asset or liability exists.

The risk to the parties of a swap agreement is reduced by the fact that no transfer of principal is involved. The cash exchanged between the parties is usually the net interest differential only.

In general, interest rate swaps are off-balance-sheet items, disclosed in the footnotes to the financial statements. With respect to the income statement, swap payments flow through other income or expense. The recording of capital gains or losses arises only in the event that one party to a swap agreement defaults. In such a circumstance, the defaulting party is required to make a lump sum payment to the other party in exchange for the release of their obligations under the contract. The amount of the lump sum payment represents the capital gain/loss recorded by each party.
(1) Accounting at Date of Opening Position:

Any premium paid or received at date of opening shall be carried as an asset (paid) or liability (received) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).

(2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where the company does not elect to recognize gain/loss currently):
  - Swaps, collars and forwards shall be valued at amortized cost in a manner consistent with hedged item.
  - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
    - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
    - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
    - For other derivative instruments the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
  - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
  - If during the life of the derivative instrument it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent that it ceased to be an effective hedge.

- Open derivative instruments hedging items carried at market value (where company does not elect to recognize gain/loss currently):
  - Swaps, collars or forwards shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.
• Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

• For hedges where the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.

• Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):

  • The foreign exchange premium (discount) on the currency contract will be amortized into income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.

  • Amortization is not required if the contract was entered into within a year of maturity.

  • A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as done to translate the hedged item.

  • The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate.

  • The statement value of the currency contract equals the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract. The cumulative unrealized gain/(loss) equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened.

  • Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.

  • For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
• If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

• Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

• For hedges of items which are not subject to IMR, derivative instruments shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.

• For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.

(3) Cash Flows and Income:

• Where the cost of the derivative instrument is not combined with the hedged item:

  • Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2.

  • Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.

• Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.

(4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):

• Exercise — The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.

• Sale, maturity, expiry, or other closing transaction of a derivative instrument which is an effective hedge — Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.
• Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

• Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on derivative instruments acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.

  • For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

(c) Futures

(1) Accounting at Date of Acquisition:

Positions in futures contracts shall be initially valued at the amount of cash deposits (i.e., basis or book value of the contract), if any, placed with a broker. Subsequent additions (reductions) in cash deposits plus changes in contract value from date of contract opening (i.e., variation margin) paid (received) will increase (decrease) the book value of the futures contract.

(2) Statement Value:

• Hedges of Items Carried at Amortized Cost (where the company does not elect to recognize gain/loss currently):
  
  • Futures shall be valued at book value.
  
  • Book value of open futures contracts need not be amortized.
  
  • For hedges where the cost of the futures contract is combined with the hedged item, the statement value would be equal to cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.
  
  • If during the life of the futures contract it is no longer effective as a hedge, valuation at book value (deferral accounting) ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized as an adjustment to surplus to the extent it ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding.

• Hedges of Items carried at Market Value (where company does not elect to recognize gain/loss currently):
Changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently consistent with the hedged item. Statement value will be limited to the cash deposits outstanding.

Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

For hedges where the variation margin of the futures contract is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately.

Open foreign currency futures contracts hedging foreign currency exposure on item(s) denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):

The foreign exchange premium (discount) on the currency contract will be amortized into investment income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. The cumulative income recognized since the contract was opened should be reported as recognized variation margin received or (paid).

Amortization is not required if the contract was entered into within a year of maturity.

A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as is done to translate the hedged item. The cumulative unrealized gain/(loss) which equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened should be reported as recognized variation margin received or (paid).

The statement value of the currency futures contract is book value, including any increase (decrease) for amortization of foreign exchange (premium) discount ((c)(i) above) plus the foreign exchange translation gain/(loss) ((c)(ii) above), which is reported as deferred variation margin.

Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.
For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value would equal the cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.

If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

Companies which elect to recognize gain/loss currently on futures contracts acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

For hedges of items which are not subject to IMR, changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently as unrealized gain/loss adjustment to surplus. Statement value will be limited to the cash deposits outstanding.

For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.

(3) Gain/Loss on Termination:

- Settlement at maturity of a futures contract — The remaining variation margin of the futures contract shall become an adjustment to the cost or proceeds of the hedged item(s) received, disposed of or held, individually or in aggregate.

- Sale or other closing transaction of a futures contract which is an effective hedge — any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.

- Gain/loss on termination of futures contracts will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

- Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on futures contracts acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.
• For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

41. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contain the following guidance relating to insurance futures and insurance future options:

Insurance Futures and Insurance Futures Options

The statutes, regulations and administrative rulings of the insurers domiciliary state establish the authority to engage in transactions with respect to insurance futures and insurance futures options. In the absence of specific written authority, the Insurance Department of the insurers domiciliary state should be consulted as to such authority.

In those jurisdictions which authorize transactions with respect to insurance futures and insurance futures options, an insurance company is generally permitted, subject to applicable quantitative limitations, to use such instruments to hedge against adverse development in its incurred losses. This strategy typically would involve any or a combination of (i) the purchase of insurance futures contracts, (ii) the purchase of a call option on insurance futures contracts, or (iii) the sale (writing) of a put option on insurance futures contracts.

Insurance Futures Contracts:

An insurance futures contract is a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto. An insurance futures contract also may be defined more specifically under the statutes, regulations and administrative rulings of a particular state. In connection with a given insurance futures position, an insurer is required by the listing exchange to maintain a margin deposit with respect to the underlying insurance futures contracts purchased.

An insurer should report the amount of any margin deposit as an asset on its balance sheet, which deposit should be reflected as an aggregate write-in for other than invested assets. The specific statutory accounting treatment of increases or decreases in the value of the subject contracts will depend on whether the insurance futures position constitutes a hedge of the insurers incurred losses. The determination of whether an insurance futures position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures position that does not constitute a hedge, the following presents both hedge accounting and other than hedge accounting treatment. Other than hedge accounting should be used in the event that an original hedge position loses its character as such, until such time as the position is terminated as required by state law.

Insurance Futures - Hedge Accounting:

The following treatment would be applicable to insurance futures positions that effectively hedge an insurers incurred losses. With respect to any insurance futures position which corresponds to incurred losses for the current reporting period, any increases (decreases) in the value of the insurance futures contracts should be reported as an increase (decrease) in the insurers other income, as an aggregate write-in for miscellaneous income for the subject period. With respect to any insurance futures position which corresponds to a period beyond the current reporting period, any increases (decreases) in the value of the underlying insurance futures contracts should be reported as a direct increase (decrease) in the insurers surplus, as an aggregate write-in for gains and losses in surplus. When such insurance futures position thereafter corresponds to a current reporting period, the initial increase (decrease) in direct surplus should be reversed and such amount should be appropriately reported as an increase (decrease) to the insurers other income, as an aggregate write-in for miscellaneous income for the current period, along with any current changes in value of the insurance futures contracts. In either of the foregoing instances, the increase (decrease) in the market value of the insurance futures contracts should either (i) increase (decrease) the aggregate write-in for other than invested assets, to the extent that such
increase (decrease) effects the corresponding margin deposit, or (ii) increase (decrease) cash or other assets, to the extent of mark-to-market payments that are not maintained as a margin deposit. When the insurance futures position is eventually closed, any corresponding margin balance (i.e., aggregate write-in for other than invested assets) shall be transferred to the insurers cash or other assets, as appropriate.

Insurance Futures - Other than Hedge Accounting:

If the insurance futures position is no longer effective as a hedge, any increases (decreases) in the value of the insurance futures contracts should be reported as an aggregate write-in for miscellaneous income. When the insurance futures positions eventually close, any corresponding margin balance (i.e., aggregate write-in for other than invested assets) should be transferred to the insurers cash or other assets, as appropriate.

Options on Insurance Futures Contracts:

An insurance futures option is either a put or call option on an insurance futures contract. An insurance futures call option is a contract under which the holder has the right to purchase the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date. An insurance futures put option gives the holder the right to sell the underlying insurance futures contract. The consideration paid (received) for the purchase (sale) of an insurance futures option is referred to as a premium. Because all insurance futures options relate to an underlying insurance futures contract, the statutory accounting treatment of insurance futures options generally follows the treatment afforded insurance futures contracts.

An insurer should report the amount of any premium paid for an insurance futures option as an asset on its balance sheet, which premium should be reflected as an aggregate write-in for other than invested assets. Similarly, an insurer should report the amount of any premium received for the sale (writing) of an insurance futures option as a liability on its balance sheet, which premium should be reflected as an aggregate write-in for liabilities. The specific statutory accounting treatment of increases or decreases in the market value of the subject insurance futures option will depend on whether such position constitutes a hedge of the insurers incurred losses. As with insurance futures contracts, the determination of whether a particular position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures option position that does not constitute a hedge, the following presents both hedge accounting and other than hedge accounting treatment. Other than hedge accounting should be used in the event that an original hedge position loses its characters as such, until such time as the position is terminated as required by state law.

Options on Insurance Futures Contracts - Hedge Accounting:

The following treatment would be applicable to insurance futures options positions that effectively hedge an insurers incurred losses.

(a) Purchase of Call Options — With respect to any call option which corresponds to incurred losses for the current reporting period, any increases (decreases) in the market value of the option should be reported as an increase (decrease) in the insurers other income, as an aggregate write-in for miscellaneous income for the subject period. With respect to any call option which corresponds to a period beyond the current reporting period, any increases (decreases) in the market value of the underlying option should be reported as a direct increase (decrease) in the insurer’s surplus, as an aggregate write-in for gains and losses in surplus. When such option thereafter corresponds to a current reporting period, the initial increase (decrease) in direct surplus should be reversed and such amount should be appropriately reported as an increase (decrease) to the insurer’s other income, as an aggregate write-in for miscellaneous income for the current period, along with any current changes in the market value of the option.
If the option position is terminated through a closing transaction, the corresponding balance of the asset (i.e., aggregate write-in for other than invested assets) should be eliminated, with a corresponding charge to cash or other assets, as appropriate. If the option is exercised, the corresponding balance of the asset should be eliminated, with a corresponding charge to either (i) insurance futures margin (i.e., aggregate write-in for other than invested assets), to the extent of margin deposit requirements, or (ii) cash or other assets, as appropriate. If the option expires, the corresponding balance of the asset should be eliminated, with an appropriate decrease to the insurer's other income, as an aggregate write-in for miscellaneous income.

(b) Sale (Writing) of Put Options — The statutory accounting treatment for the sale (writing) of insurance futures put options is essentially the mirror image of the foregoing treatment presented with respect to purchased call options. Upon termination (through a closing transaction), exercise or expiry of the put option, the corresponding balance of the liability (i.e., aggregate write-in for liabilities) should be eliminated, in the mirror image of the foregoing treatment.

Options on Insurance Futures Contracts - Other than Hedge Accounting:

If the insurance futures option position is no longer effective as a hedge, any increases (decreases) in the value option should be reported as an aggregate write-in for miscellaneous income.

42. The NAIC Annual Statement Instructions for both Life, Accident and Health and Property and Casualty companies require the following disclosures for derivative instruments:

Instruction:

Disclose the following information by category of derivative financial instrument:

a. A description of the Company's objectives for holding or issuing derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives including the classes of derivative financial instrument used.

b. The nature and terms of derivative financial instruments, including, at a minimum, a discussion of: 1) the credit and market risk of those instruments, and 2) the cash requirements of those instruments (including the effects of possible termination payments).

Illustration for Interest Rate Swaps (Companies should modify the following to reflect appropriately their own circumstances):

The Company uses interest rate swaps to reduce market risks from changes in interest rates and to alter interest rate exposures arising from mismatches between assets and liabilities. Under interest rate swaps, the Company agrees with other parties to exchange, at specified intervals, the difference between fixed-rate and floating-rate interest amounts calculated by reference to an agreed notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by either party. A single net payment is usually made by one counterparty at each due date. See Schedule DB.

The Company is exposed to credit-related losses in the event of nonperformance by counterparties to financial instruments, but it does not expect any counterparties to fail to meet their obligations given their high credit ratings. The credit exposure of interest rate swaps is represented by the fair value (market value) of contracts with a positive fair value (market value) at the reporting date.
Illustration for All Other Derivatives Listed in Schedule DB (Caps, Collars, Futures, etc.):

The note(s) may resemble the illustration for interest rate swaps. For additional illustrations, see C.M. Antis’ Financial Accounting Series Special Report, Illustrations of Financial Instrument Disclosures (No. 144-c), December 1994, published by the Financial Accounting Standards Board.

43. The following guidance for derivatives used for income generation was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996:

INCOME GENERATION ACCOUNTING PROJECT
EXECUTIVE SUMMARY
JULY 10, 1996

INTRODUCTION

Income Generation transactions are ones where the company writes (or sells) derivative instruments to generate additional income or return to the company. They include covered options, caps and floors such as when a company writes an equity call option on stock which it already owns. Currently they represent a small portion of the insurance industry’s derivative activity in terms of number of companies involved, number of transactions, and dollar amounts involved. The possibility of greater company involvement in the future exists given recent guidance and inclusion in the Model Investment Law.

Because these transactions involve writing derivative transactions, they expose the company to potential future liabilities for which the company receives a premium up front. Because of this risk, state laws and the Model Investment Law impose dollar limitations and additional constraints requiring that they be “covered,” i.e., that there be offsetting assets which can be used to fulfill potential obligations. To this extent the combination of instruments works like a reverse hedge where an asset owned by the company in essence hedges the derivative risk.

As with derivatives in general these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

GENERAL ATTRIBUTES

The proposed accounting and reporting approach is intended to meet (1) Regulatory needs focusing on company and Industry solvency (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

1. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset.

2. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the NAIC Accounting Practices and Procedures Manual and in the Annual Statement Instructions regarding hedging.

3. The approach looks to the substance of the transactions involved.
   • It matches the accounting of the derivative with the accounting of the covering asset or underlying interest.
It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces.

It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.

ACCOUNTING SPECIFICS

The accounting specifics attached are presented in table form. Completed sections include

- Covered Call Writing
  - Covering Item at Amortized Cost
  - Covering Item at Market
- Covered Put Writing
  - Underlying Interest at Amortized Cost
  - Underlying Interest at Market
- Covered Cap and Floor Writing
  - Covering Item at Amortized Cost
  - Covering Item at Market
- Accounting Examples
- AVR Implications
- Approval by AVR/IMR Study Group
- Formal Blanks Proposal

General

The principal features to date are:

1. The premium received is initially recorded as a deferred liability.

2. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., for bonds).

3. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it would be subject to IMR treatment if interest rate related.

4. For options which are exercised, the remaining premium would adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Covered puts and fixed income transactions have several specific features which are presented below.

Fixed Income Call Options

The principal specific features are:

1. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract.

2. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income
feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds.

3. For life insurance companies the gain or loss flows through the IMR if the underlying interest or covering asset is subject to the IMR using callable bond rules to determine the remaining life.

4. Companies writing options for income generation purposes are responsible for timely recognition of any probably losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset should be evaluated for write down or disclosure treatment along the lines of Codification Issue Paper #5 Definition of Liabilities, Loss Contingencies, and Impairments of Assets taking into consideration all relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income.

**Puts**

The principal features are:

1. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a company wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the company might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case.

2. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest.

3. As with covered call writing, companies writing put options for income generation purposes are responsible for timely recognition of any probably losses that may occur as a result of the strategy.

**Fixed Income Caps and Floors**

The principal specific features are:

1. The value of the premium received would be amortized into income over the life of the contract. For caps and floors, where the company is selling off possible excess interest/income, the value of the covering asset is not relevant.

2. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract’s maturity.
WRITTEN CALL OPTIONS – INCOME GENERATION
PROPOSED STATUTORY ACCOUNTING TREATMENT
APPLICABLE TO ALL INSURANCE COMPANIES
JULY 30, 1996

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET AT AMORTIZED COST</th>
<th>COVERING ASSET AT MARKET VALUE</th>
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</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)</td>
<td></td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR if applicable. (3)</td>
<td></td>
</tr>
</tbody>
</table>

NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.


3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.
### STATUS OF OPTION

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>UNDERLYING INTEREST AT AMORTIZED COST</th>
<th>UNDERLYING INTEREST AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR if applicable.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust acquisition cost by premium received.</td>
<td>Adjust acquisition cost by premium received.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognized net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

### NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.
<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET AT AMORTIZED COST</th>
<th>COVERING ASSET AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value. (Alternatively carry at consideration received if within 1 yr of maturity.)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Amortize over life of contract to produce constant yield.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Record any interest expense as “Other Investment Income” – negative value.</td>
<td></td>
</tr>
<tr>
<td>Closed – Matured</td>
<td>Would usually mature at zero amortized value.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Not applicable.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain/loss on termination to flow through IMR if applicable.</td>
<td></td>
</tr>
<tr>
<td>Disclosure</td>
<td>(OPEN ITEM—being addressed by other Interested Persons.)</td>
<td>(OPEN ITEM—being addressed by other Interested Persons.)</td>
</tr>
<tr>
<td></td>
<td>Details of covered items and/or written transactions to allow actuaries to evaluate cash flow implication.</td>
<td>Details of covered items and/or written transactions to allow actuaries to evaluate cash flow implications.</td>
</tr>
</tbody>
</table>

**Generally Accepted Accounting Principles**

44. The key GAAP literature relating to hedge accounting for derivative financial instruments is found in FAS 80. Paragraphs 3 and 4 of FAS 80 state, in part:

3. A change in the market value of a futures contract shall be recognized as a gain or loss in the period of the change unless the contract meets the criteria specified in this Statement to qualify as a hedge of an exposure to price or interest rate risk. If the hedge criteria are met, the accounting for the futures contract shall be related to the accounting
for the hedged item so that changes in the market value of the futures contract are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized.

4. In applying this Statement, both of the following conditions shall be met for a futures contract to qualify as a hedge:

a. The item to be hedged exposes the enterprise to price (or interest rate) risk. In this Statement, risk refers to the sensitivity of an enterprise's income for one or more future periods to changes in market prices or yields of existing assets, liabilities, firm commitments, or anticipated transactions. To meet this condition, the item or group of items intended to be hedged must contribute to the price or interest rate risk of the enterprise. In determining if this condition is met, the enterprise shall consider whether other assets, liabilities, firm commitments, and anticipated transactions already offset or reduce the exposure. An enterprise that cannot assess risk by considering other relevant positions and transactions for the enterprise as a whole because it conducts its risk management activities on a decentralized basis can meet this condition if the item intended to be hedged exposes the particular business unit that enters into the contract.

b. The futures contract reduces that exposure and is designated as a hedge. At the inception of the hedge and throughout the hedge period, high correlation of changes in (1) the market value of the futures contract(s) and (2) the fair value of, or interest income or expense associated with, the hedged item(s) shall be probable so that the results of the futures contract(s) will substantially offset the effects of price or interest rate changes on the exposed item(s). In addition to assessing information about the correlation during relevant past periods, the enterprise also shall consider the characteristics of the specific hedge, such as the degree of correlation that can be expected at various levels of higher or lower market prices or interest rates. A futures contract for a commodity or a financial instrument different from the item intended to be hedged may qualify as a hedge provided there is a clear economic relationship between the prices of the two commodities or financial instruments, and provided high correlation is probable.

45. Paragraph 21 of FAS 52 states, in part:

A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction...A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:

a. The foreign currency transaction is designated as, and is effective, as a hedge of a foreign currency commitment.

b. The foreign currency commitment is firm.

46. The key GAAP literature relating to interest rate swap transactions is EITF 84-36, in which the Task Force concluded that:

...if there is an underlying debt obligation on the balance sheet of the company entering into the swap transaction, the company should account for the swap agreement like a hedge of the obligation and record interest expense using the revised interest rate, with any fees or other payments amortized as yield adjustments.

47. FAS 105, as amended by FAS 119, provides the following guidance on disclosures for financial instruments with off-balance sheet risk, including derivatives:
6. A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation\(^1\) (1) to deliver cash or another financial instrument\(^2\) to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity

b. Conveys to that second entity a contractual right\(^3\) (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

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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 obligations is owed to or by a group of entities rather than a single entity.

\(^2\) The use of the term *financial instrument* in this definition is recursive (because the term *financial instrument* is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

\(^3\) Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

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7. The risk of accounting loss\(^4\) from a financial instrument includes (a) the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract (credit risk), (b) the possibility that future changes in market prices may make a financial instrument less valuable or more onerous (market risk),\(^5\) and (c) the risk of theft or physical loss. This Statement addresses credit and market risk only.

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\(^4\) Accounting loss refers to the loss that may have to be recognized due to credit and market risk as a direct result of the rights and obligations of a financial instrument.

\(^5\) A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk).

17. For financial instruments with off-balance-sheet risk*, except as noted in paragraphs 14 and 15, an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:12

a. The face or contract amount (or notional principal amount if there is no face or contract amount)
b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, Disclosure of Accounting Policies.13

* Similar disclosures are required for derivative financial instruments without off-balance-sheet risk in paragraph 8 of FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.

12 In this Statement, category of financial instrument refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category. Practices for grouping and separately identifying—classifying—similar financial instruments in statement of financial position, in notes to financial statements, and in various regulatory reports have developed and become generally accepted, largely without being codified in authoritative literature. In this Statement, class of financial instrument refers to those classifications.

13 Paragraph 12 of Opinion 22 as amended by FASB Statement No. 95, Statement of Cash Flows, says:

Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, statement of cash flows, or result of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives.
b. Principles and methods peculiar to the industry in which the reporting operates, even if such principles and methods are predominantly followed in that industry.
c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

The disclosures required in paragraph 17 shall distinguish between financial instruments with off-balance-sheet risk held or issue for trading purposes, included dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

Disclosure of Credit Risk of Financial Instruments with Off-Balance-Sheet Credit Risk

18. For financial instruments with off-balance-sheet credit risk, except as noted in paragraphs 14 and 15, an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:

a. The amount of accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
b. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that
collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

19. An entity may find that disclosing additional information about the extent of collateral or other security for the underlying instrument indicates better the extent of credit risk. Disclosure of that additional information in those circumstances is encouraged.

48. FAS 119 provides the following guidance on disclosures for derivatives:

8. For options held and other derivative financial instruments not included in the scope of Statement 105 (because they do not have off-balance-sheet risk of accounting loss, as defined in Statement 105), an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:

   a. The face or contract amount (or notional principal amount if there is no face or contract amount)

   b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, Disclosure of Accounting Policies.

1 In this Statement, category of financial instrument refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category.

2 Disclosure of the face or contract amount of financial instruments, including those within the scope of Statement 105, may be misleading when the instruments are leveraged and the leverage features are not adequately disclosed. For example, the optional amounts of the interest rate swap may be misleading if the contract's settlement payments are based on a formula that multiplies the effect of interest rate changes. Disclosure of the nature and terms of those instruments requires a discussion of the leverage features and their general effects on (a) the credit and market risk, (b) the cash requirements, and (c) the related accounting policy.

9. The disclosures required in paragraph 8 of this Statement shall distinguish between derivative financial instruments held or issued for:

   a. Trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings

   b. Purposes other than trading.
10. Entities that hold or issue derivative financial instruments for trading purposes shall disclose, either in the body of the financial statements or in the accompanying notes, the following:

a. The average fair value of those derivative financial instruments during the reporting period, presented together with the related end-of-period fair value, distinguishing between assets and liabilities.

b. The net gains or losses (often referred to as net trading revenues) arising from trading activities during the reporting period disaggregated by class, business activity, risk, or other category that is consistent with the management of those activities and where those net trading gains or losses are reported in the income statement. If the disaggregation is other than by class, the entity also shall describe for each category the classes of derivative financial instruments, other financial instruments, and nonfinancial assets and liabilities from which the net trading gains or losses arose.

3 The calculation based on average fair value based on daily balances is preferable to a calculation based on less frequent intervals. It is, however, sufficient to disclose average fair value based on the most frequent interval that a trader’s systems generate for management, regulatory, or other reasons.

11. Entities that hold or issue derivative financial instruments for purposes other than trading shall disclose the following:

a. A description of the entity’s objectives for holding or issuing the derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivative financial instruments used.

b. A description of how each class of derivative financial instrument is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivative financial instruments held or issued, and when recognized, where those instruments and related gains and losses are reported in the statements of financial position and income.

4 For example, if an entity’s objective for a derivative position is to keep a risk arising from the entity’s nonderivative assets below a specified level, the context would be a description of those assets and their risk, and a strategy might be purchasing put options in a specified proportion to the assets at risk.

c. For derivative financial instruments that are held or issued and accounted for as hedges of anticipated transactions (both firm commitments and forecasted transactions for which there is no firm commitment), (1) a description of the anticipated transactions whose risks are hedged, including the period of time until the anticipated transactions are expected to occur, (2) a description of the classes of derivative financial instruments used to hedge the anticipated transactions, (3) the amount of hedging gains and losses explicitly deferred, and (4) a description of the transactions or other events that result in the recognition in earnings of gains or losses deferred by hedge accounting.

5 For purposes of the disclosure of hedging gains and losses, the term explicitly deferred refers to deferrals in separate accounts in the manner required by FASB Statement No. 80, Accounting for Futures Contract, for hedges of anticipated transactions and by FASB Statement No. 52, Foreign Currency Translation, for hedges of firm commitments. Those deferrals are in contrast to implicit deferrals that are (a) embedded in related carrying amounts for hedges of recognized assets and liabilities or (b) not recorded because changes in the value of the hedging instrument are not recognized.
12. Entities are encouraged, but not required, to disclose quantitative information about interest rate, foreign exchange, commodity price, or other market risks of derivative financial instruments that is consistent with the way the entity manages or adjusts those risks and that is useful for comparing the results of applying the entity's strategies to its objectives for holding or issuing the derivative financial instruments. Quantitative disclosures about the risks of derivative financial instruments are likely to be even more useful, and less likely to be perceived to be out of context or otherwise misunderstood, if similar information is disclosed about the risks of other financial instruments or nonfinancial assets and liabilities to which the derivative financial instruments are related by a risk management or other strategy.

13. Appropriate ways of reporting the quantitative information encouraged in paragraph 12 will differ for different entities and will likely evolve over time as management approaches and measurement techniques evolve. Possibilities include disclosing (a) more details about current positions and perhaps activity during the period, (b) the hypothetical effects on equity, or on annual income, of several possible changes in market prices, (c) a gap analysis of interest rate repricing or maturity dates, (d) the duration of the financial instruments, or (e) the entity's value at risk from derivative financial instruments and from other positions at the end of the reporting period and the average value at risk during the year. This list is not exhaustive, and entities are encouraged to develop other ways of reporting the quantitative information.

OTHER SOURCES OF INFORMATION

49. Excerpts from the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force Meeting on June 2, 1996

Derivatives Projects

Ann Bottelli (Prudential Insurance) gave a report on four derivatives projects that had been ongoing in the Invested Asset Working Group. The first report dealt with a blanks proposal to add a column to Schedule DB Part E Section 1 dealing with off-balance sheet exposure for derivatives securities. This amount is needed for risk based capital calculations. Following Ms. Bottelli’s comments, a motion was made and seconded to adopt the blanks proposal and send it on to the Blanks Task Force. That motion passed. (Attachment A)

Ms. Bottelli next gave a report on the required disclosure for anticipatory hedging. The disclosure would bring NAIC disclosure in line with generally accepted accounting principles (GAAP) disclosure requirements for derivatives securities. Following Ms. Bottelli’s comments on the reporting mechanisms, Larry Gorski (Ill.) pointed out that this report and blanks proposal was in no way an endorsement for the use of anticipatory hedging, which he pointed out is prohibited in certain states. Following Mr. Gorski’s comments, a motion was made and seconded to adopt the blanks proposal and forward it to the Blanks Task Force. That motion passed. (Attachment B)

Next, Ms. Bottelli gave a report dealing with guidance for the interest maintenance reserve (IMR) for hedging. This guidance will appear in the Financial Examiners Handbook and will deal with IMR gains and losses from derivative hedges. A motion was made and seconded to send this proposal to the Accounting Handbook and Instructions Working Group. That motion passed. (Attachment C)

Finally, Ms. Bottelli gave a report dealing with the accounting for income generating derivative transactions. This report contained two blanks proposal items, as well as definitional material that should be added to the Accounting Practices and Procedures Handbook. Following Ms. Bottelli’s comments, Mr. Gorski again pointed out that this report was in no way an endorsement of using derivatives for anything other than hedging purposes. Following some concerns by the working group members that they did not have sufficient time to review this proposal, a motion was made and seconded to receive the report by the working group. (Attachment D) That motion was passed by the working group. Ron Newton (Texas) asked if the two blanks proposals would be sent to the Blanks Task Force. Mr. Gorski responded that they would be held until a final review could be done by the Invested Asset Working Group members.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies and for Property and Casualty Insurance Companies, Chapter 8, Other Admitted Assets
- Annual Statement Instructions for Property and Casualty Insurance Companies
- Annual Statement Instructions for Life, Accident and Health Insurance Companies
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 81—Foreign Currency Transactions and Translations
- Minutes of the December 14, 1996, meeting of the Financial Condition (EX4) Subcommittee (Minutes included the Executive Summary of the Income Generation Accounting Project dated July 10, 1996)

Generally Accepted Accounting Principles
- FASB Statement No. 52, Foreign Currency Translation
- FASB Statement No. 80, Accounting for Futures Contracts
- FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk
- FASB Statement No. 107, Disclosure about Fair Value of Financial Instruments
- FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments
- FASB Emerging Issues Task Force Issue No. 84-7, Termination of Interest Rate Swaps
- FASB Emerging Issues Task Force Issue No. 84-14, Deferred Interest Rate Setting
- FASB Emerging Issues Task Force Issue No. 84-36, Interest Rate Swap Transactions
- FASB Emerging Issues Task Force Issue No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions
- FASB Emerging Issues Task Force Issue No. 87-2, Net Present Value Method of Valuing Speculative Exchange Contracts
- FASB Emerging Issues Task Force Issue No. 88-8, Mortgage Swaps
- FASB Emerging Issues Task Force Issue No. 90-17, Hedging Foreign Currency Risk with Purchased Options
- FASB Emerging Issues Task Force Issue No. 91-1, Hedging Intercompany Foreign Currency Risks
- FASB Emerging Issues Task Force Issue No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions
- FASB Emerging Issues Task Force Issue No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115

Other Sources of Information
- Minutes of the June 2, 1996 meeting of the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force
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Statutory Issue Paper No. 86

Securitization

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans which serve as collateral for mortgage-backed securities.


3. In June 1996 the Financial Accounting Standards Board issued FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125). This standard supersedes FASB Statement No. 77, Reporting by Transferors for Transfers of Receivables with Recourse, (FAS 77) and FASB Technical Bulletin 85-2, Accounting for Collateralized Mortgage Obligations (CMOs) (FTB 85-2). The types of transactions contemplated in the statement recognize recent innovations in the financial markets. It addresses transfers accomplished through securitizations as well as other types of transfers.

4. The purpose of this issue paper is to establish statutory accounting principles for asset securitizations and securitizations of policy acquisition costs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper is not intended to address transfers accomplished by means other than securitization.

SUMMARY CONCLUSION

Accounting for Securitizations of Financial Assets

5. As used in this issue paper a financial asset shall be defined as cash, evidence of an ownership interest in an entity, or a contract that conveys both

   a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with a second entity; and

   b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.

6. A securitization in which the transferor surrenders control over the financial asset transferred shall be accounted for as a sale, with recognition of proceeds and measurement of a gain or loss only to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The portion of the securitization for which beneficial interests in the transferred assets are
received shall not be accounted for as a sale, but shall be treated as an exchange of assets with no measurement of a gain or loss. All other securitizations shall be accounted for as secured borrowings in accordance with paragraph 13.

7. The transferor has surrendered control if, and only if, all of the following conditions are met:
   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
   b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.
   c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

8. A beneficial interest shall be defined as the right to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest or principal inflows to be “passed through” or “paid through,” premiums due guarantors, and residual interests. Residual interests are interests in the cash flows of the trust or other entity, after the cash flows of structured securities issued by the trust are met.

9. Upon completion of the securitization of financial assets meeting the criteria for sales treatment required by paragraph 7, the transferor shall:
   a. Eliminate the transferred assets from the statement of financial position.
   b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer.
   c. Record in its statement of financial position, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities).
   d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 9.e.) and liabilities incurred in consideration as proceeds of the sale.
   e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value.
   f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses in the Investment Income section of the Underwriting and Investment Exhibit.

10. The successor (transferee) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.
11. A qualifying special-purpose entity (including CMO special-purpose entities) as used in this issue paper must meet all of the following conditions:

   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

      1. Holding title to transferred financial assets
      2. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
      3. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
      4. Distributing proceeds to the holders of its beneficial interests.

   b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

**Investments in Special-Purpose Entities**

12. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.

**Secured Obligations and Collateral**

13. Securitizations of financial assets that do not meet the criteria for sale treatment set forth in paragraph 7 shall be presumed to be secured borrowings and shall be recorded as follows. Financial assets shall remain on the reporting entity’s books and a liability shall be recorded to reflect the proceeds from the issuance of any type of certificate. Non-cash proceeds shall be recorded as a contra liability and netted against the liability. The liability shall be reduced as the obligation to holders of beneficial interests is repaid. Financial assets pledged as collateral shall not be offset against the liability reflecting the proceeds of the transaction.

**Recognition of Servicing Rights**

14. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the income statement. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). The servicing asset or liability shall be measured in a manner consistent with paragraphs 13 and 35 through 38 of FAS 125.
Sales of Future Revenues

15. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

DISCUSSION

16. The conclusions reached in this issue paper are consistent with the statutory guidance set forth in the minutes of the March 26, 1990 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group) which address securitization of mortgage loans and mortgage-backed securities except that the gain on sale shall be recognized immediately rather than deferred and amortized over the life of the retained interests. This issue paper is also consistent with the minutes of the February 21, 1992 meeting of the Emerging Accounting Issues Working Group which addressed financings secured by mortgage loans which have related repurchase agreements.

17. This issue paper adopts FAS 125, with the following modifications:

   a. This issue paper requires servicing rights assets to be nonadmitted.

   b. This issue paper does not permit sales treatment for transactions where recourse provisions exist or where “call” or “put” options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances.

   c. This issue paper requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FAS 125 requires the encumbered assets to be reported separately from unencumbered assets.

   d. This issue paper does not address transfers of financial assets accomplished in a manner other than through securitizations whereas FAS 125 does address such transfers.

   e. Paragraph 14 is rejected as it is not applicable.

18. With respect to securitizations meeting the criteria of paragraph 7, statutory and GAAP do not recognize as a sale, any portion of the transfer for which securities representing beneficial interests in the transferred assets (e.g., CMOs) are obtained by the transferor. Statutory and GAAP do recognize that the securitized assets (e.g., mortgages) are no longer assets of the reporting entity and that the reporting entity has essentially replaced the transferred assets with securities representing a beneficial interest in the transferred assets.

19. This paper is consistent with GAAP in that the securities representing the retained beneficial interests are recorded by the reporting entity in the statement of financial position at their allocated carrying value, since the securities represent a continuing control over a previous asset, albeit in a different form. Thus, no gain or loss is recognized on the retained beneficial interest.

20. The guidance set forth in this issue paper with respect to reporting pledged collateral and the related liability for the proceeds received from transactions not recognized as sales on a gross basis and not offsetting those amounts is consistent with the guidance set forth in Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities.

21. This issue paper is consistent with the current statutory guidance provided in the Life/A&H Accounting Practices and Procedures Manual. Recording the proceeds received currently for future
revenue as a liability is consistent with the concepts of conservatism and recognition in the Statement of Concepts.

22. While servicing rights meet the definition of an asset, they do not meet the definition of an admitted asset. The conclusion to nonadmit the asset is consistent with the concept of conservatism in the Statement of Concepts.

Drafting Notes/Comments
- Extinguishment of debt is addressed in Issue Paper No. 80—Debt.
- Levelized commissions are addressed in Issue Paper No. 71—Policy Acquisition Costs and Commissions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
23. The Life/A&H Accounting Practices and Procedures Manual, Chapter 17, Other Liabilities, provides the following guidance with respect to the sale of future revenue.

Sale of Future Revenues

The immediate recognition of proceeds from certain transactions characterized as “sale” of future revenues in income and/or surplus has been determined to be inappropriate for purposes of statutory reporting. These transactions are sometimes referred to as “securitization” and are sometimes characterized as selling “deferred acquisition costs”. Accordingly, a liability should be established for the amount of proceeds, which shall be reduced as the proceeds are repaid.

24. The Minutes of the March 26, 1990 meeting of the Emerging Accounting Issues Working Group provide the following guidance.

Accounting for Real Estate Mortgage Investment Conduits (REMIC’s)

The subject of accounting for REMIC’s (Real Estate Mortgage Investment Conduits) has been discussed or deferred at a number of meetings of the working group. It was discussed briefly at the October 13, 1988 meeting (EI 88–4) and in greater detail at subsequent meetings. An issue summary prepared by Norris Clark (Attachment A) was used as the initial basis for discussion.

Under the Tax Reform Act of 1986, mortgages may be placed in trust and certificates, junior and senior, may be issued. Certificate holders are entitled to receive a proportionate share of the payments made on the underlying pool of mortgages. This mortgage pass–through may be treated as a Real Estate Mortgage Investment conduit (REMIC) under the act. Generally an insurer will transfer a pool of mortgages to the trust and receive the Senior Certificates (seniors) and Junior Certificates (juniors). The seniors are then offered to the public at a somewhat lower interest rate than the pool will produce. The insurer will retain the juniors, at least initially. Rights to receive payment on the juniors will be subordinate to the rights of the seniors. A third type of instrument, a residual instrument, may also be part of the REMIC. This part may be very small.

At its June 5, 1989 meeting (89–2), the working group reached conclusions on the following two issues relating to REMIC’s:

1. If an insurer holds a junior, how should it report its holdings, as a bond or equity or some other form of security?

   It was the consensus of the working group that the holding of a junior should be reported as a bond.

2. If a junior is a bond, how should it be valued?
The consensus of the working group was that it should be valued in accordance with procedures established by the NAIC Securities Valuation Office. (However, this conclusion was modified by the group during its March 26, 1990 meeting. See Number 3. below.)

A third issue was also discussed at the June 5, 1989 meeting (EI 89–2) and at subsequent meetings of the working group. At the December 4, 1989 meeting (EI 89–4) the working group reviewed a paper (Attachment B) in the form of an issue summary prepared by Ransom Jones of Goldman, Sachs. Mr. Jones and Katherine Mason agreed to illustrate a transaction for the March 1990 meeting (Attachment C). Mr. Clark also provided an illustration (Attachment D) of the transaction which had been the impetus for his original issue summary.

Following a discussion of the material provided, the working group reached the following conclusions on accounting for these transactions:

1. How should the allocated basis of each of the layers or tranches be determined?

   The consensus of the working group was that fair market value should be used in determining the allocated basis for each tranche.

2. Should the exchange of mortgages and the issuing of securities be considered a sale and should a gain or loss be recognized?

   The group agreed that the transaction should be considered a sale. It further agreed that any gain or loss arising from the sale of the senior tranche should be recognized. The working group concluded loss, if any, should be recognized immediately. A gain on the sale should be deferred and amortized over the life of the juniors and residuals but in no event faster than the risk retained by the insurer is eliminated.

3. At what value should the juniors and/or residuals be carried by the insurer?

   It was the consensus of the working group that juniors and residuals should initially be carried at their allocated book value. They should be amortized as cash is received and should be periodically assessed as to realizability and valued downward.

25. The minutes of the February 21, 1992, meeting of the Emerging Accounting Issues Working Group provide the following guidance.

   Accounting for Financing Secured by Mortgage Loans

This issue was previously discussed under the caption “Secured Borrowing” during the September 16, 1991 and December 9, 1991 meetings (EI 91-3 and EI 91-4). An issue summary was prepared for this meeting but was revised, particularly with respect to the accounting issues, during the meeting (See Attachment D).

This is an arrangement that creates participation interests in a block of existing mortgage loans for the purposes of utilizing such interests as collateralization for obtaining temporary financing.

Specifically, an insurer (the “transferor”) transfers a designated portion of its portfolio of mortgage loans to a grantor trust. In exchange, the transferor receives mortgage pass-through certificates evidencing one hundred percent beneficial ownership of the trust and the underlying mortgage loans. This phase of the transaction is effected by a pooling and servicing agreement between the transferor and the transferee.

The transaction utilizes a senior/subordinated structure for the transferee. One or more classes of certificates has a senior or first priority lien on the mortgage loan cash flows. One or more classes of subordinated certificates has a subordinated lien on the assets of the trust. The
creation of the subordinated certificates may allow the senior certificates to obtain an investment
grade rating from various rating agencies.

In the second phase of the transaction, the transferor enters into a reverse repurchase facility
with a financier providing cash for liquidity. This facility is initially in place for one year (with an
option by the transferor for an additional year) and will allow the transferor to enter into discrete
repurchase transactions for the sale to the financier and subsequent repurchase by the transferor
of the higher rated certificates held by the transferor pursuant to the first phase.

An individual repurchase transaction, as drawn on the line of credit provided by the financier, may
be for a term as short as overnight or as long as two years. Each transaction is required to be
over-collateralized by an amount which will vary relative to the length of the term of the particular
sale/repurchase. The certificates that are transferred and serve as collateral remain registered in
the name of the transferor, and principal and interest payments thereon shall, absent foreclosure,
be for the account of the transferor. At such times as the transferor has satisfied its obligation to
the financier under the repurchase facility, the transferor holds the certificates free and clear of
any liens.

In the event that the transferor fails to make a required payment of the repurchase price or if the
transferor is the subject of insolvency proceedings, then an event of default occurs which enables
the financier to foreclose on the collateral and pay itself back the amount of such borrowings. Any
collateral remaining would be returned to the transferor.

Preliminary, the working group identified the following issues and reached the following
conclusions:

1. Is the transfer of mortgages to the trust a non-economic event?

   Yes. The transaction would be non-economic because an economic event requires a
   permanent transfer of the risks and rewards of ownership as defined by FAS 77.

2. How should the ownership of the mortgages be accounted for on the balance sheet of
   the transferor?

   The mortgages should continue to be reported on the balance sheet at the transferor’s
   carrying value, continue to be amortized, and continue to be reported on Schedule B with
disclosure in the Notes to the Financial Statements. Each mortgage which has been
transferred to the trust should be denoted with a ‘c’ to indicate its use as collateral as
described on page 2-1 of the NAIC Annual Statement Instructions for Life, Accident and
Health Insurance Companies and the Instructions for Fire and Casualty Insurance
Companies.

   Disclosure in the Notes to the Financial Statements should include the number and dollar
   amounts of mortgages transferred to the trust by type, dollar amounts of the senior and
   junior certificates, and the life of the trust. Appropriate disclosure should also be made,
as applicable, in the General Interrogatories of the Annual Statement. Since the
mortgages continue on the books of the insurer/transferor under their previous
classifications, no assets or liabilities are shown by the company for the trust.

3. How should an insurance company account for borrowings under this type of
   arrangement?

   The borrowing transaction would result in an increase in cash or cash equivalents, and a
   like increase in the liability, borrowed money.

   A disclosure should be made in the Notes to the Financial Statement as required for
   “Borrowed Money”.
Because of the interest of and certain concerns raised by industry observers at the meeting, the chairman agreed to expose the foregoing preliminary conclusions through these minutes. Final adoption of conclusions by the working group will be made at the June 1992 meeting.

In addition, proposed Accounting Manual language was developed by the working group. The proposed language (for exposure) is attached as Attachment E.

Generally Accepted Accounting Principles

26. FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
   b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
   c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:
   a. Derecognize all assets sold
   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, 32, and 35-41)

11. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
   a. Derecognize all assets sold
   b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
   c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)
   d. Recognize in earnings any gain or loss on the sale.
The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

3 Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 35-38).

Financial Assets Subject to Prepayment

14. Interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement (paragraph 233).4

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 released⁵ from being the primary obligor under the liability, either judicially or by the creditor.

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⁵ If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the
effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding.

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets.

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value.

e. For all servicing assets and servicing liabilities:
   (1) The amounts of servicing assets or liabilities recognized and amortized during the period.
   (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.
   (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37.
   (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57(c)).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on
sale to the transferor’s competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity must meet both of the following conditions:
   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
      (1) Holding title to transferred financial assets
      (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
      (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
      (4) Distributing proceeds to the holders of its beneficial interests.
   b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassert control over the individual assets held in the trust, and the transferor “can effectively assign his interest and his creditors can reach it.” In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

   7 The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

   8 Scott’s Abridgment of the Law on Trusts, §156 (Little, Brown and Company, 1960), 296.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:
   a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
   b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
   c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
   d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

   9 In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.
a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor’s effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Retained Interests

33. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 31.

Servicing Assets and Liabilities

35. Servicing of mortgage loans, credit card receivables, or other financial assets includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.
36. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, unless the transferor securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced. Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than adequate compensation to the servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing, the contract results in a servicing liability.

37. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:
   a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).
   b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 33, 34, and 42-46).
   c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).
   d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11(b), 11(c), and 42-46).
   e. Account separately for rights to future interest income from the serviced assets that exceed contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.
   f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).
   g. Subsequently evaluate and measure impairment of servicing assets as follows:
      (1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location.

10 For example, for mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans.

(2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.

(3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).
h. Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows from the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

38. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset.

Fair Value

42. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

43. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

44. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Value

45. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred

b. The amount that would be recognized in accordance with FASB Statement No. 5, Accounting for Contingencies, as interpreted by FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.
Securitizations

47. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or salestype leases) also are common. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this Statement.

48. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to a special-purpose entity, commonly a trust. In “pass-through” and “pay-through” securitizations, receivables are transferred to the special-purpose entity at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the special-purpose entity. In “revolving-period” securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the special-purpose entity uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

49. Beneficial interests in the qualifying special-purpose entity are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the qualifying special-purpose entity.

50. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Revolving-Period Securitizations

51. The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract’s value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

52. Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving-period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized.

53. Revolving-period securitizations may use either a discrete trust, used for a single securitization, or a master trust, used for many securitizations. To achieve another securitization
using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors. Adding receivables to a master trust, in itself, is neither a sale nor a secured borrowing under paragraph 9, because that transfer only increases the transferor's beneficial interest in the trust's assets. A sale does not occur until the transferor receives consideration other than beneficial interests in the transferred assets. Transfers that result in an exchange of cash, that is, either transfers that in essence replace previously transferred receivables that have been collected or sales of beneficial interests to outside investors, are transfers in exchange for consideration other than beneficial interests in the transferred assets and thus are accounted for as sales (if they satisfy all the criteria in paragraph 9) or as secured borrowings.

Isolation of Transferred Assets in Securitizations

54. A securitization, carried out in one transfer or a series of transfers, may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

55. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

56. In other securitizations, a similar corporation transfers financial assets to a special-purpose entity in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies largely because the transferor is highly rated. Depending on facts and circumstances, the Board understands that those “single-step” securitizations often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 83). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

57. Still other securitizations use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those “two-step” structures:

a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide “excessive” credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.

b. Second, the special-purpose corporation transfers the assets to a trust, with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high
credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.

c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

The Board understands that the “two-step” securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

58. A securitization by an entity subject to a possible receivership under procedures different from the U.S. Bankruptcy Code may isolate transferred assets from the transferor and its creditors even though it uses only one transfer directly to a special-purpose entity that issues beneficial interests to investors and the transferor provides credit or yield protection. For example, the Board understands that assets transferred by a U.S. bank are not subject to an automatic stay under Federal Deposit Insurance Corporation (FDIC) receivership and could only be obtained by the receiver if it makes the investors completely whole, that is, the investors must be paid compensation equivalent to all the economic benefits contained in the transferred assets, including bargained-for yield, before the FDIC could obtain those assets. Those limited powers appear insufficient to place the transferred assets within reach of the receiver. The powers of other receivers for entities not subject to the U.S. Bankruptcy Code, and of bankruptcy trustees in other jurisdictions, vary considerably, and therefore some receivers may be able to reach transferred financial assets, and others may not.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 1—Consolidation of Majority-Owned Subsidiaries
- Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities
- Issue Paper No. 42—Sale of Premium Receivables
- Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies
- Minutes of the March 26, 1990, meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force

Generally Accepted Accounting Principles
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 87

Other Admitted Assets

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Issue Paper No. 4—Definition of Assets and Nonadmitted Assets (Issue Paper No. 4) provides the definition of admitted and nonadmitted assets.

2. Current statutory accounting guidance for admitted assets is provided throughout the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P & C Accounting Practices and Procedures Manuals). Other admitted assets are specifically addressed in Chapter 8 of both manuals.


4. The purpose of this issue paper is to establish statutory accounting principles for admitted assets which are not specifically addressed in other issue papers.

SUMMARY CONCLUSION

5. The definition and accounting treatment for admitted assets is outlined in paragraphs 2 and 3 of Issue Paper No. 4 as follows:

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

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

a. Specifically identified within the Codification as a nonadmitted asset or
b. Not specifically identified within the Codification as an admitted asset.

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

6. Consistent with paragraph 5, the following assets shall be considered admitted and shall be reported in accordance with Issue Paper No. 4. These admitted assets are not addressed in other issue papers.

**Collateral Loans**

7. Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment and meet the definition of assets as defined in Issue Paper No. 4, and, are admitted assets to the extent they conform to the requirements of this paper. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following further limitations:

- **Loan Impairment - Determination** as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected, the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell such collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5).

- **Nonadmitted Asset -** In accordance with *Issue Paper No. 90—Nonadmitted Assets* (Issue Paper No. 90) collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

**Cash Value of Life Insurance Where the Reporting Entity is Owner and Beneficiary**

8. The cash value of life insurance policies where the reporting entity is the owner and beneficiary is similar to a cash deposit that is realizable on demand. As such, the cash value of a life insurance policy as of the date to which premiums have been paid, less any outstanding policy loans and surrender charges, shall be reported as an admitted asset.

**Receivables for Securities**

9. Sales of securities are recorded as of the trade date. A receivable due from the broker is established in instances when a security has been sold, but the proceeds from the sale have not been received. Unless the receivable for securities, other than a receivable arising from the sale of a security which was acquired on a “To Be Announced” (“TBA”) basis and which has yet to be actually received (see paragraph 12), meets the criteria noted in paragraph 11 below, the receivable for securities is an admitted asset to the extent it conforms to the requirements of this paper.

10. An evaluation shall be made in accordance with Issue Paper No. 5, to determine if there is an impairment. If, in accordance with Issue Paper No. 5, it is probable the balance, or any portion thereof, is uncollectible, any uncollectible receivable shall be written off and charged against income in the period the determination is made. If it is reasonably possible, but not probable, the balance or a portion of the balance is uncollectible and is not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

11. Receivables for securities not received within 15 days from the settlement date shall be nonadmitted, and shall be classified as other than invested assets.
12. Receivables arising from the secondary sale of securities acquired on a TBA basis which have not yet been received by the seller in the secondary sale transaction, may be admitted until the security is exchanged for payment. TBA securities are originally purchased well in advance of the actual date of security issuance (frequently 90 days or more). Accordingly, secondary sales of securities so acquired may occur before the date of issuance. Sales of securities so acquired always include a provision that requires simultaneous delivery of the security and receipt of consideration. Upon the secondary sale, and prior to the actual receipt, of a security acquired on a TBA basis, the seller in the secondary sale transaction records a liability for the book value of the security thus sold and a receivable for the consideration reflected in the secondary sale transaction. Profits or losses emanating from the secondary sale transaction are recorded in the same manner as profits and losses emanating from any other sale transaction involving an investment.

Other Amounts Receivable Under Reinsurance Contracts

13. Amounts receivable from Servicemen’s Group Life Insurance (SGLI) or Federal Employees’ Group Life Insurance (FEGLI) pools and Federal Crop Insurance programs shall be reported as admitted assets.

Guaranteed Investment Contracts

14. Guaranteed Investment Contracts (GICs) purchased for investment purposes meet the definition of assets as defined in Issue Paper No. 4, and are admitted assets to the extent they conform to the requirements of this paper.

15. Purchases for which all contractual rights and ownership of the GIC result in an investment similar to a corporate bond shall be accounted for in accordance with the guidance in Issue Paper No. 26—Bonds, excluding Loan-backed and Structured Securities.

16. An investment in a GIC payment stream is created when an intermediary purchases individual GICs, pools them, and sells the rights to the payment stream. These investments shall be reported as other long-term invested assets and shall be carried at amortized cost consistent with current statutory accounting.

17. If, in accordance with Issue Paper No. 5, it is probable that the carrying value of a GIC is not fully recoverable the investment shall be considered impaired. Accordingly, the cost basis of the investment shall be written down to the undiscounted estimated cash flows and the amount of the write down shall be accounted for as a capital loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

State Guarantee Association Promissory Notes

18. State guarantee associations have the statutory authority to reinsure any or all of the policies of an impaired or insolvent insurer. When this is done, the assuming carrier receives assets supporting the liabilities from the insolvent company’s estate and/or the responsible state guarantee association. If available, the state guarantee association transfers cash at the closing of the transaction. Promissory notes may be utilized in the event a guarantee association does not have the funds on hand or is unable to raise the funds by the closing date. These promissory notes are essentially credit risk free because the notes are backed by all member insurers of an association.

19. Promissory notes issued by state guarantee associations taken by an insurance company in connection with funding an assumption reinsurance agreement meet the definition of assets as defined in Issue Paper No. 4, are admitted assets to the extent they conform to the requirements of this paper, and shall be reported as a note receivable - other than invested assets.
DISCUSSION

20. For those items specifically addressed within this issue paper the principles established are consistent with current statutory accounting practices except as follows:

a. With respect to the principles outlined in paragraph 7, collateral loans, the conclusion modifies current statutory accounting to require the evaluation and recording of an impairment in value of collateral loans. The method of evaluating and recording an impairment of value is consistent with FAS 114 which was adopted in Issue Paper No. 37—Mortgage Loans.

b. With respect to the principles outlined in paragraph 11, receivables for securities, the conclusion modifies current statutory accounting to require that amounts not received within 15 days from the settlement date be nonadmitted. Issue Paper No. 4 states that an asset not readily available to satisfy policyholder obligations “shall be recorded as a nonadmitted asset and charged against surplus.” This is consistent with the Statement of Concepts, which states that an insurer’s “ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.” Receivables for securities not received within 15 days from the settlement date are not considered readily available to satisfy policyholder obligations. Nonadmitting such receivables is also consistent with the conservatism concept of the Statement of Concepts.

c. With respect to the principles outlined in paragraph 17, guaranteed investment contracts, the conclusion modifies current statutory accounting to require the write-off of the portion of the asset not expected to be recoverable in accordance with Issue Paper No. 5.

d. Deposits in suspended depositories are considered nonadmitted assets as provided for in Issue Paper No. 90 as the amounts are not available to satisfy obligations to policyholders.

By requiring reporting entities to reflect impairments in the value of other admitted assets, the conclusions reached above are consistent with other issue papers on invested assets and specifically with Issue Paper No. 5. It is also more conservative than allowing a reporting entity to carry such impaired assets at a value in excess of that which may be realizable.

21. Current statutory accounting, as outlined in Chapter 8 of the P&C Accounting Practices and Procedures Manual, lists certain other assets that may be considered admitted assets should “sufficient subsidiary records to provide detail for the annual statement schedule of other invested assets” exist. The examples provided are investments not considered to be prevalent or significant in industry and as such have not been included in this issue paper.

22. This issue paper adopts FTB 85-4 with modification. FTB 85-4 permits recognition of the cash surrender value of life insurance where the reporting entity is either the owner or beneficiary; whereas this issue paper requires that the reporting entity be both the owner and beneficiary. The cash values of life insurance policies meet the definition of assets defined in Issue Paper No. 4. When the reporting entity is not the owner of the policy, the cash value is not readily available to satisfy policyholder obligations and, therefore, is a nonadmitted asset.

23. The statutory accounting principles discussed above are consistent with the concepts of conservatism and recognition as outlined in the Statement of Concepts.
Conservatism

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency.

Recognition

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

Drafting Notes/Comments

- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets, discusses and outlines the appropriate treatment for the impairment of assets.
- Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities, discusses and outlines the appropriate recording and valuation of bonds.
- Issue Paper No. 37—Mortgage Loans, discusses and outlines the appropriate recording and valuation of mortgage loans.
- Issue Paper No. 43—Loan-Backed and Structured Securities, discusses and outlines the appropriate recording and valuation of structured securities.
- Specific other admitted assets discussed in current statutory guidance excerpted below but not addressed in this issue paper are discussed in other issue papers.
- The NAIC Annual Statement Instructions regarding Receivables for Securities were adopted by the Blank’s Task Force on October 14 and 15, 1996, to be effective beginning with 1998 Annual Statements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting Guidance

Chapter 8 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance:

The various states specify certain assets, all or portions of, which may be admitted in determining statutory unassigned surplus. This chapter discusses some of the more common assets that are not discussed in other chapters. Each company should consult the laws and regulations of their state of domicile regarding other admitted assets.

Other admitted assets not discussed in this chapter include premium notes, reinsurance receivables, deferred and uncollected premiums, tax refunds, investment income due and accrued, and investment settlements pending. In no event should a specifically described nonadmitted asset be recorded as an admitted asset or be used to defer an expense that has been incurred and has no liquidating value, e.g., material used in previous advertising campaigns or supplies that are not resalable.

Collateral Loans

Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment. The various states regulate a life insurance company's investment in collateral loans. Generally, these regulations deal with the legal form of the assignment and the relationship of the market value of the pledged investment to the collateral loan. The amount of the loan in excess of the permitted relationship is customarily nonadmitted. Also, the collateral loan may be admissible only if the collateral itself is an authorized investment. In some
jurisdictions the collateral must be combined with the like securities held directly in determining if maximum investment limitations are being exceeded.

Guaranteed Investment Contracts (GICs)

Absent specific statutory authority, the purchase of a guaranteed investment contract by an insurer for investment purposes, either directly or in the secondary market, should be considered the purchase of a direct corporate obligation of the issuer and such asset should be considered a bond and should be reported in Schedule D. This treatment applies only when the purchaser acquires all contractual rights and ownership of the guaranteed investment contract.

Absent specific statutory guidance, the purchase by an insurer of a payment stream in the secondary market should be reported in Schedule BA as “Other Long-Term Invested Assets.”

The normal NAIC valuation procedures apply.

State Guarantee Association Promissory Notes

State guarantee associations have the statutory authority to reinsure any or all of the policies of an impaired or insolvent insurer. When this is done, the assuming carrier receives assets supporting the liabilities from the insolvent company’s estate and/or the responsible state guarantee association. If available, the state guarantee association transfers cash at the closing of the transaction. Promissory notes may be utilized in the event a guarantee association does not have the funds on hand or is unable to raise the funds by the closing date.

These promissory notes are essentially credit risk free because the notes are backed by all member insurers of an association. Funds to transfer the obligations via assumption reinsurance are obtained through assessments of solvent companies doing business in the state. If the maximum assessment allowed in any one year does not provide the necessary funds, additional assessments are made as soon thereafter as permitted by the guaranty association act.

Promissory notes issued by state guarantee associations taken by an insurance company in connection with funding an assumption reinsurance agreement shall be reported on the asset page, aggregate write-ins for other than invested assets line, as a note receivable–miscellaneous asset. Interest income shall be recorded in the Summary of Operations on the line entitled aggregate write-ins for miscellaneous income.

All promissory notes issued subsequent to the effective date of this guidance are subject to the following condition. The note must contain a clause which stipulates that in the event the state guarantee association fails to fulfill its obligations on the promissory note, the note and the related liabilities assumed by the insurance company will revert back to the state guarantee association.

This guidance is effective June 7, 1995.

The following paragraphs are addressed in other issue papers and as such the Chapter 8 discussion is not excerpted here.

- Partnerships and Joint Ventures
- Amounts Due From Affiliated Companies
- Investments in Real Estate, Equipment and Other Assets Involving Leases
- Electronic Data Processing and Related Equipment
- Foreign Exchange Adjustment
- Deposits on Interest Rate Futures Contracts
- Amounts Receivable Relating to Uninsured Accident and Health Plans
- Derivative Instruments
- Insurance Futures and Insurance Futures Options
- Reverse Mortgages
Chapter 8 of the P & C Accounting Practices and Procedures Manual provides the following guidance:

The various states specify certain assets that may be admitted in determining statutory unassigned surplus. This chapter discusses some of the more common assets that are not discussed in other chapters. Each company should consult the laws and regulations of its state of domicile regarding limitations on admissibility and a more specific description of other admitted assets.

(a) The amount fairly estimated as recoverable on cash deposited in a closed bank or trust company is an admitted asset, if qualifying under the provisions of the various states prior to the suspension of such bank or trust company.

(b) Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment. The accounting is similar to that for mortgage loans. If the individual loan exceeds the excess of the permitted relationship of the market value of the pledged investment to the collateral loan, the excess is customarily treated as a nonadmitted asset. Also, the collateral loan is admitted only if the collateral itself is an authorized investment.

(c) Guaranteed Investment Contracts (GICs)

Absent specific statutory authority, the purchase of a guaranteed investment contract by an insurer for investment purposes, either directly or in the secondary market, should be considered the purchase of a direct corporate obligation of the issuer and such asset should be considered a bond and should be reported in Schedule D. This treatment applies only when the purchaser acquires all contractual rights and ownership of the guaranteed investment contract.

Absent specific statutory guidance, the purchase by an insurer of a payment stream in the secondary market should be reported in Schedule BA as “Other Long-Term Invested Assets.”

(e) Other invested assets that do not fall within the scope of previous chapters require sufficient subsidiary records to provide detail for the annual statement schedule of other invested assets. Examples of such assets which may be admissible:

1. Loan on or investments in oil and gas production payments, except those considered securities and listed in the schedule of stocks;
2. transportation equipment;
3. timber deeds;
4. mineral rights;
5. equipment trusts;
6. deposits relating to interest rate futures contracts;
7. any other admitted investment not clearly includable in other schedules.

The statutory method for accounting for lease and sale leaseback arrangements is governed largely by the form of the agreement to which the insurance company is party. The Financial Accounting Standards Board statements (FASB) 13, 28 and 66 are commonly used as guidelines where not in conflict with statutory accounting practices. Conservatism and policyholder protection are the objectives.

(o) Cash value of life insurance policies where the company is beneficiary is somewhat analogous to a cash deposit that is realizable on demand. The admissibility of the cash value of life insurance policies is based on general business practice. The admitted amount is the cash value as of the date to which premiums have been paid. (See Chapter 16 Other Income.)
The following paragraphs are addressed in other issue papers and as such the Chapter 8 discussion is not excerpted here.

(d) Partnerships and Joint Ventures
(f) Funds held by or deposited with reinsured companies
(g) Bills receivable taken for premiums
(h) Reinsurance recoverable on loss payments
(i) Federal income taxes recoverable
(j) Electronic Data Processing Equipment
(k) Interest, Dividends and Real Estate Income Due and Accrued
(l) Amounts due from affiliated companies
(m) Equities and deposits in pools and associations
(n) Amounts Receivable Relating to Uninsured Accident and Health Plans (See Chapter 13 - Other Liabilities.)
(p) Lease-purchase transactions

Derivative Instruments

Insurance Futures and Insurance Futures Options

Reverse Mortgages

26. The NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies specify that the following be classified as Other Than Invested Assets:

Amounts not received within 15 days of the end of the period that are due from brokers when a security has been sold, but the proceeds have not yet been received.

Generally Accepted Accounting Principles

27. Asset recognition is governed by CON 6. An asset is defined in paragraphs 25 and 26 of CON 6 as follows:

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

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

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Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (Webster’s New World Dictionary of the American Language, 2d college ed. [New York Simon and Schuster 1982], p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).
28. Accounting for the impairment of a loan is contained in FAS 114, as amended by FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures (FAS 118). Pertinent excerpts are as follows:

8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.

13. When a loan is impaired as defined in paragraph 8 of this statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan’s effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan’s observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The creditor may choose a measurement method on a loan by loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of collateral) is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premiums or discounts), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.

29. Accounting for purchases of life insurance is contained in FTB 85-4. Pertinent excerpts are as follows:

1. How should an entity account for an investment in life insurance?

Response

2. The amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset. The change in cash surrender or contract value during the period is an adjustment of premiums paid in determining the expense or income to be recognized under the contract for the period.

Effective Date And Transition

3. The provisions of this Technical Bulletin are effective for insurance policies acquired after November 14, 1985.

Appendix

Background

4. In November 1970, the AICPA issued an Accounting Interpretation entitled “Accounting for Key-Man Life Insurance.” That Accounting Interpretation identified the cash surrender value method as generally accepted accounting for purchases of life insurance. New
types of life insurance contracts, new provisions in traditional contracts, and changes in
the insurance industry have led some to question the 1970 Accounting Interpretation. In
October 1984, the AICPA's Accounting Standards Executive Committee (AcSEC)
approved an Issues Paper entitled "Accounting for Key-Person Life Insurance." In the
Issues Paper, AcSEC reaffirmed support of the cash surrender value method as the only
generally accepted method. The AcSEC position differed from the position of the AICPA
Insurance Companies Committee, which supported use of a different method in certain
circumstances. AcSEC was concerned that diversity would develop in practice because
of the difference between those positions and requested that the FASB consider the
matter.

5. A premium paid by a purchaser of life insurance serves a variety of purposes. A portion
of the premium pays the insurer for assumption of mortality risk and provides for recovery
of the insurer's contract acquisition, initiation, and maintenance costs. Another portion of
the premium contributes to the accumulation of contract values. The relative amounts of
premium payment credited to various contract attributes change over time as the age of
the insured party increases and as earnings are credited to previously established
contract values.

6. An insurance contract is significantly different from most investment agreements. The
various attributes of the policy could be obtained separately through term insurance and
purchase of investment. The combination of benefits and contract values could not,
however, typically be acquired absent the insurance contract. Continued protection from
mortality risk and realization of scheduled increases in contract accumulation usually
requires payment of future premiums.

7. The payment of insurance premiums may take a number of different forms. The
insurance contract may be purchased through payment of a single premium, as opposed
to the typical series of future premiums. Alternatively, the premium payments may be
made through loans from the insurance company that are secured by policy cash
surrender values. The pattern of premium payments is a decision that does not alter the
underlying nature of the insurance contract.

Consideration of Comments Received on Proposed Technical Bulletin

8. A proposed Technical Bulletin, Accounting for Business-Owned Life Insurance, was
released for comment on June 28, 1985. Forty-seven letters of comment were received
on the proposed Technical Bulletin. Certain of the comments received and consideration
of them are discussed in the following paragraphs.

9. Some respondents view the dominant objective of a life insurance contract to be
investment. Subject to certain criteria evidencing an intent to continue the contract, they
maintain that the contract meets the definition of an asset established in paragraph 19 of
Concepts Statement 3, which states, "Assets are probable future economic benefits
obtained or controlled by a particular entity as a result of past transactions or events" (footnote reference omitted). Those who hold this view suggested that such contracts
should be accounted for using methods that result in reporting the investment in life
insurance at amounts different from those stipulated in the contract.

10. This Technical Bulletin does not take that view. The current capacity to realize contract
benefits is limited to settlement amounts specified in the contract. Additional amounts in
excess of cash surrender value, which would be reported as assets under the various
alternative accounting methods suggested, are created by future events, which typically
include premium payments and earnings credited to contract amounts.

11. Paragraph 123 of Concepts Statement 3 discusses the occurrence of past events and
the role of future events in the recognition of assets.
Since the transaction or event giving rise to the enterprise's right to the future economic benefit must already have occurred, the definition excludes from assets items that may in the future become an enterprise's assets but have not yet become its assets. An enterprise has no asset for a particular future economic benefit if the transactions or events that give it access to and control of the benefit are yet in the future.

12. Some respondents asserted that reporting an insurance investment at its realizable value represents an accounting based on liquidation values. Those respondents suggested that the entity acquiring an insurance contract is, in many cases, economically or contractually committed to maintain the contract in force. They maintained that such a commitment virtually assures that benefits in excess of premiums paid would be realized and that the policy should be reported on a basis other than its cash surrender value.

13. This Technical Bulletin does not accept that view. The amount realizable under an insurance investment represents settlement values agreed to by an independent buyer and seller. The variety of yields and contract accumulation patterns available in the insurance marketplace provides the buyer and seller a variety of insurance and settlement options. There is no compelling justification to depart from the recording of such contracts based on agreed provisions. The commitment referred to by respondents is, in the staff's view, a commitment to ensure that assets are available to meet contractual obligations. The presence of such a commitment does not change the measurement of the asset that is expected to satisfy the obligation.

14. Some respondents asserted that policy features, most notably the business exchange rider, were significant factors in determining the proper accounting for the policy. The business exchange rider allows a company to use values in an existing policy to insure a different employee when the originally insured employee leaves the company. They maintain that this feature gives the employer the ability to transfer the contract freely and enhances the employer's ability to realize the future value of the investment. They further maintain that the increased probability of realizing future values should lead to the reporting of amounts in excess of cash surrender value.

15. This Technical Bulletin rejects that view. The business exchange rider is a significant development in the design of business insurance products and reduces additional policy costs if a covered employee leaves the company. Such a provision does not affect the realization of future benefits under the insurance contract, nor does it change the traditional underwriting decisions involved in insuring a new life. Instead, the provision only reduces the cost of obtaining those benefits by allowing a new employee to be insured without the costs that are typically associated with obtaining a new policy.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 8
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 8
- NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities
- Issue Paper No. 37—Mortgage Loans
- Issue Paper No. 68—Business Combinations and Goodwill
- Issue Paper No. 90—Nonadmitted Assets
Generally Accepted Accounting Principles
- FASB Statement No. 114, Accounting by Creditors for the Impairment of a Loan
- Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables
- FASB Emerging Issues Task Force No. 88-5, Recognition of Insurance Death Benefits
- FASB Technical Bulletin 85-4, Accounting for Purchases of Life Insurance

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 88

Mortgage Guaranty Insurance

STATUS
Finalized March 16, 1998

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Mortgage guaranty insurance protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor. It differs from other types of property and casualty insurance in that coverage is long-term, and in most cases premiums are level and paid monthly. Most states require issuers of mortgage guaranty contracts to be monoline insurers and impose limitations on the aggregate amount of risk insured based on geographic territories. Additionally, states may limit mortgage guaranty insurers to reinsure with only selected reinsurers.


3. Although GAAP guidance for mortgage guaranty insurance is provided in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), certain aspects of accounting for mortgage guaranty insurance contracts are specifically excluded from FAS 60. The aspects of FAS 60 not applicable to mortgage guaranty insurance relate to premium revenue, claims cost recognition, and acquisition costs.

4. To fill this void in GAAP, the AICPA exposed a draft statement of position in October 1980. The statement of position proposed that premiums be recognized evenly over the anticipated policy term. Costs of acquiring business such as salaries and commissions, generally would be deferred and amortized as the related premiums were earned. Losses on claims, including expenses of settlement, such as appraisal fees, generally would be recognized as of the initial default date.

5. The statement of position was never issued and there has been no further GAAP guidance relating to accounting for premium revenue and claims cost recognition and acquisition costs relating to mortgage guaranty insurance contracts.

6. Although there is no promulgated GAAP guidance, common practice is to recognize revenue as follows:
   a. For single premium plans, revenues are recognized over the policy life in relation to the expiration of risk;
   b. For annual premium plans, revenues are earned on a pro rata basis over the applicable year;
   c. For monthly premium plans, revenues are earned either in the month received or the month due.
7. Losses and loss adjustment expenses are generally recognized on the default date regardless of when claims are reported to the insurer.

8. The purpose of this issue paper is to establish statutory accounting principles for recording premium revenue and the liability for unpaid losses and loss adjustment expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Premium Revenue Recognition

9. Written premium shall be recorded in accordance with Issue Paper No. 53—Property and Casualty Contracts - Premiums (Issue Paper No. 53). Premium revenue shall be earned as follows:

   a. For single premium plans, revenues shall be earned over the policy life in relation to the expiration of risk;

   b. For annual premium plans, revenues shall be earned on a pro rata basis over the applicable year;

   c. Additional first year premiums on nonlevel policies shall be deferred and amortized to income over the anticipated premium paying period of the policy in relation to the expiration of risk;

   d. Initial renewal premiums that are higher than subsequent renewals shall be deferred and amortized over the remaining anticipated premium paying period in a manner consistent with additional first year premiums (i.e., in relation to the expiration of risk);

   e. For monthly premium plans, revenues shall be earned in the month to which they relate.

10. When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, contingency reserve, and the estimated future renewal premium on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed. If an insurer utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the financial statements.

Unpaid Losses and Loss Adjustment Expense Recognition

11. Unpaid losses and loss adjustment expenses shall be recognized in accordance with Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses (Issue Paper No. 55). For mortgage guaranty insurance contracts, the date of default shall be considered the incident that gives rise to a claim as discussed in Issue Paper No. 55. If a claim is ultimately presented, the date of default shall be considered the loss incurred date.

12. The process for estimating the liability shall include projections for losses that have been reported as well as those that have been incurred but not reported. The estimates shall be made based on historical data, trends, economic factors, and other statistical information including paid claims, reported losses, insurance in force statistics, and risk statistics.

13. Real estate and mortgages are acquired by mortgage guaranty insurers to mitigate losses. These assets shall be shown on the balance sheet at the lower of cost or net realizable value, net of
encumbrances. Any gains or losses from the holding or disposition of these assets shall be recorded as a component of losses incurred. Any rental income or holding expenses shall be included in loss adjustment expenses.

**Contingency Reserve**

14. In addition to the unearned premium reserve, mortgage guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction. The annual addition to the liability shall equal 50% of the earned premium from mortgage guaranty insurance contracts and shall be maintained for ten years regardless of the coverage period for which premiums were paid. With commissioner approval, when required by statute, the contingency reserve may be released in any year in which actual incurred losses exceed 35% of the corresponding earned premiums. Any such reductions shall be made on a first-in first-out basis. Changes in the reserve shall be recorded directly to surplus.

**Disclosures**

15. Mortgage guaranty insurers shall make all disclosures required by other issue papers within the codification, including but not limited to the requirements of Issue Paper No. 55, and Issue Paper No. 77—Disclosures of Accounting Policies, Risks & Uncertainties, and Other Disclosures.

**DISCUSSION**

16. This issue paper is not consistent with current statutory guidance as follows:

a. **Premium Recognition**

i. The P & C Accounting Practices and Procedures Manual distinguishes premiums for high risk policies from other policies. The conclusions reached in this issue paper make no such distinction because the concept is implicit in the requirement to earn revenues in relation to the expiration of risk.

ii. Certain states dictate by statute that a specific formula, table, or earnings curve be utilized to determine earned premiums. To the extent that the requirements are based on the exposure period and the relative risk during that period, they are consistent with the concepts set forth in this issue paper.

iii. The Mortgage Guaranty Insurance Model Act provides no specific guidance on premium revenue recognition other than the requirement to establish an unearned premium reserve. The method of establishing such reserve is based on regulation of the state of domicile.

iv. Current statutory guidance has no requirement to establish a premium deficiency reserve.

b. **Contingency Reserve**

The contingency reserve may be recorded through income or directly to surplus. This issue paper requires changes in the reserve to be recorded through surplus.

i. The Model Act requires that the contingency reserve shall be computed as an amount equal to 50% of the unearned premium after the establishment of the unearned premium reserve. This issue paper requires the establishment of a contingency reserve based on earned premium. Consistent with the Model Act, this issue paper provides that reserves can be reduced if Commissioner approval is obtained. However, Commissioner approval of a reserve reduction will only be considered as a viable means of reducing a reserve
where the reporting entity can clearly demonstrate to the commissioner that the existing reserves are excessive.

17. Issue Paper No. 53 requires recognition of premium on a pro-rata basis over the period of exposure except when specific issue papers require different methods because the level of risk may vary significantly over the exposure period. Losses related to mortgage guaranty policies can occur over an exposure period which extends for the term of the mortgage. The pattern of normal loss incidence is not uniform over the exposure period and tends to peak in the earlier years. This issue paper provides guidance for premium recognition that is based on the exposure period of the contract and the underlying risk. Recognizing premiums over the exposure period and in relation to the underlying risk allows insurers to determine methods appropriate to the contracts they write versus requiring insurers to use methods that may not appropriately reflect such risks. Premiums collected on an annual payment plan may not be sufficient to cover the risk in early years. Subparagraph 9 b. requires annual premiums to be earned over the applicable year and does not permit an insurer to accrue premiums which may be collected in future years. Additional first year premiums and initial renewal premiums that are higher than subsequent renewals may be front loaded to expedite the collection of premium. Subparagraphs 9 c. and 9 d. require an insurer to defer the revenue and amortize it in relation to the expiration of risk.

18. The changes referred to in paragraph 16 were made to improve consistency in reporting among insurers that offer mortgage guaranty contracts as well as to improve consistency in reporting between reporting periods. This is consistent with the Statement of Concepts which states:

Consistency

The regulators’ need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

19. This issue paper expands current statutory guidance with respect to the recognition of losses. The P & C Accounting Practices and Procedures Manual provides guidance that losses shall be recognized when they occur. This issue paper defines the occurrence date as the date of default of a loan.

20. This issue paper is inconsistent with Issue Paper No. 22 which requires rental income on property to be recorded as investment income whereas this issue paper requires recognition of rental income as a reduction of loss adjustment expense.

21. The inconsistency between mortgage guaranty insurers and all other insurers in the reporting of all real estate obtained through foreclosure and in the recognition of rental income is reflective of the nature of the risks underwritten. Losses on real estate incurred by mortgage guaranty insurers can be viewed as resulting from underwriting activities and not investing activities. Because mortgage guaranty insurers are generally required to be monoline companies, and are prohibited from investing in real estate, the inconsistency with all property casualty insurers will not hinder evaluation of the mortgage guaranty insurers results.

22. The contingency reserve does not meet the definition of a liability which is set forth in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets. However, it is consistent with the “ultimate objective of solvency regulations” as stated in the Statement of Concepts. This states:
the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.

Additionally, recording the contingency reserve as a liability is consistent with the Statement of Concepts which states:

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

23. This issue paper is inconsistent with the guidance set forth in the AICPA exposure draft for mortgage guaranty insurance for the following reasons:

a. This issue paper requires that acquisition costs shall be accounted for in accordance with Issue Paper No. 71—Policy Acquisition Costs and Commissions rather than deferred as indicated in the exposure draft.

b. Paragraph 14 of this issue paper requires insurers to establish a contingency reserve. The AICPA exposure draft has no such requirement.

24. This issue paper is consistent with Issue Paper No. 55 which requires the ultimate cost of all known and unknown claims as well as related settling costs to be recorded when an insured event occurs.

Drafting Notes/Comments
- U.S. Mortgage Guaranty Tax and Loss Bonds and Contingency Reserve (for tax purposes, the Mortgage Guaranty Account) are addressed in Issue Paper No. 83—Accounting for Income Taxes.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
25. Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement, of the P & C Accounting Practices and Procedures Manual provides the following guidance with respect to accounting for mortgage guaranty insurance: (only pertinent excerpts are included)

**Insured Risk**

The nature of the insured risk is influenced by certain factors which set the mortgage guaranty insurance product in some respects apart from other types of insurance.

1. **Exposure Period**

The period of exposure for a particular risk is significantly longer for mortgage insurance than for other property/liability insurance products. The exposure period for mortgage insurance can run for the term of the mortgage; however, the average policy life is seven years. The policy is terminated when the mortgage obligation is satisfied or the lender elects to cancel or not renew the policy.

Mortgage insurance is renewable at the option of the insured and at the renewal rate quoted when the policy commitment was issued. Disability income and certain life and
health insurance products are other policies written with similar terms regarding renewal rate and cancellation.

In contrast to mortgage insurance, most property/liability products need not be renewed by the insurer at the expiration of the policy. The fact that mortgage insurance is guaranteed renewable at a definite rate is one of the factors necessitating the establishment of a contingency reserve. In effect, this reserve protects not only against catastrophic economic events, but also against a decrease in the quality of the insurance portfolio because of adverse selection at each renewal period.

2. Losses

The insured peril—the default of a borrower—arises from the credit risk associated with mortgage loans. The frequency of loss is strongly influenced by economic conditions. The likelihood of individual default is further increased if the property has deteriorated since a borrower in financial difficulty will be less able to sell the property at a price sufficient to discharge the mortgage.

Mortgage insurance losses can be divided into three categories:

(a) Normal losses associated with regular business cycles, interruptions in the borrower’s earning power and random errors made in evaluating the insured’s willingness or ability to meet mortgage obligations.

(b) Defaults caused by adverse local economic conditions.

(c) Widespread defaults caused by a severe depression in the U.S. economy.

The possible magnitude of loss contemplated in the last category has no analogy in any other private property/liability line of insurance.

3. Loss Incidence

Losses are incurred over an exposure period which can, as previously discussed, run for the term of the mortgage. The pattern of normal loss incidence is not uniform over the exposure period. The loss incidence peaks in the earlier years.

When a loan has been delinquent two or four months, the mortgage insurance policy requires the lender to notify the insurer. Further, the lender agrees to institute foreclosure proceedings six to nine months from the date of delinquency. Foreclosure can require an additional 18 months which could mean a considerable delay between the delinquency and the date of the claim. Without adverse economic conditions, most delinquencies do not result in a claim. Once a claim is presented, payment normally is made within one or two months and ultimate loss costs can be known relatively quick. An exception is the case where an insurer chooses to take the title to the property and sell it. Thus, reporting of losses and loss payments occur within the period that title is held by the insurer.

Pool Insurance

In addition to insuring mortgage loans on an individual basis (primary insurance), mortgage guaranty insurance is provided on pools of mortgage loans. Typically, such insurance supports mortgage-backed securities or group sales. Unlike other pool or group products, each loan is individually underwritten.

Pool insurance may be provided on loans that are already insured by primary insurance, in which case the pool insurance provides an additional level of coverage, or it may be provided on loans without primary insurance (usually loans with loan-to-value ratios below 80%). Generally, pool insurance provides 100% coverage and includes a stop-loss limit of liability which may range...
from 5% to 20% of the initial aggregate principal balance. Because of regulatory requirements in some states, pool insurance usually uses participating reinsurance arrangements to limit the exposure of any one mortgage insurer of a pool of loans to 25% of each mortgage insured.

Pool insurance policies are not cancelable by the insurer except for nonpayment of premium. These policies are generally written on mortgage pools having terms of up to 30 years. However, for all practical purposes, it is expected that the life of each pool will be considerably shorter than 30 years and will result in average policy life of 8 to 12 years. This compares to an individual policy which has an average term of 7 years.

In the case of default, the insurer has the same options as with individual insured mortgage loans. However, pool insurance loss payments are reduced by any settlements under primary insurance and subject to the stop-loss limit.

Three kinds of mortgage-backed securities which use pool insurance are described as follows:

1. **Mortgage-Backed Bonds**
   
   Issued by banks, savings and loan associations and other mortgage lenders as a general obligation of the issuing institution. These bonds are collateralized by a pool or mortgages and have a stated rate of return and maturity date.

2. **Mortgage Revenue Bonds**
   
   Issued by state and local housing authorities to support housing affordability for targeted income groups.

3. **Mortgage Pass-Through Certificates**
   
   Issued by banks, savings and loan associations, mortgage bankers and others providing an undivided interest in a pool of mortgages with principal and interest payment passed to the certificate holder as received.

Special Regulatory Requirements for Mortgage Insurers

1. **Risk Ratio**

   Since the inception of the private mortgage insurance industry in 1957, private mortgage insurers have been required to operate within a 25-to-1 ratio of risk to surplus, a ratio which many state insurance commissioners have determined to be prudent for the protection of lenders. For the purposes of arriving at this risk ratio, the regulatory authorities have defined “risk” as the total amount of exposure (percentage coverage) relating to the insurance in force, and “surplus” as policyholders’ surplus (capital, paid-in surplus, and unassigned surplus) plus the contingency reserve.

2. **Statutory Contingency Reserve**

   This is a special statutory reserve designed to protect policyholders against loss during a period of extreme economic contraction. By law, insurers must set aside 50 cents of each premium dollar earned and maintain the contingency reserve for a period of ten years, regardless of the length of coverage of the particular policy for which premium was paid. In most states, with the approval of the insurance commissioner, the contingency reserve may be reduced when losses in a calendar year exceed 35% of earned premiums (20% in some states).
REAL ESTATE

Generally, real estate owned by mortgage guaranty insurance companies consists of two types; (a) properties occupied by the company; or (b) real estate owned as a result of claim settlement. Real estate owned and held for use by the company is accounted for in the same manner as other fire and casualty companies.

Claims Settlement Costs

The cost of real estate acquired in the settlement of claims is similar in computation to that acquired by other insurers through a foreclosure process. Generally the cost of real estate acquired through foreclosure or in settlement of claims includes the outstanding principal balance of the mortgage loan on the date of foreclosure, plus accumulated interest, unpaid real estate taxes, insurance premiums, and all other costs necessary to obtain clear title and place the property in good repair.

If a property acquired in settlement of a claim is rented prior to disposal, the rental income received on such property is recorded as a reduction of loss adjustment expenses. Generally, expenditures for ordinary repairs is necessary to maintain the property in good operating condition, utilities, and real estate taxes paid after the acquisition of the property are recorded as loss adjustment expenses. Expenditures for major improvements made to the property are generally capitalized.

Statement Value

The statement value of real estate acquired in settlement of claims is generally accounted for at its net realizable value (the amount of cash, or its equivalent, expected to be realized upon disposal, net of costs such as maintenance and selling expenses required to be incurred prior to sale). In lieu of writing down real estate when realizable value is less than cost, a loss reserve may be established as a liability.

The excess of acquisition cost over realizable value on property disposed of at a later date is recorded to losses paid for the period in which the reduction in realizable value has been determined.

LOSSES

Recognition

The underlying goal of estimating unpaid losses is to have unpaid losses reflect the liability outstanding for losses that have been incurred as of the report date. Losses are recognized as they occur and not as they are reported to the company. Because of this basis of recognition, unpaid losses are grouped as (1) reported and (2) incurred but not reported (IBNR). Reported losses are those incurred losses of which the mortgage insurer has been notified by the lender through delinquent loan reporting and/or filing a claim for payment. The incurred but not reported losses are those losses that have occurred that have not been reported to the company.

Valuation

1. Estimation of Reported Losses Unpaid

Unpaid losses are estimated based on predictions of loss frequency and loss severity. These estimates are based on historic data, trends, economic information, and other statistical information.
Loss frequency and loss severity estimates are made for three separate categories:

(a) Insured loans that have resulted in the conveyance of property which remains unsold

(b) Insured loans in the process of foreclosure

(c) Insured loans in default

2. Incurred But Not Reported Losses

With the reported and unpaid loss category of the reserve representing the liabilities for reported claims and delinquencies, the mortgage insurer must also record a liability for losses that are incurred but not reported.

Estimates of loss frequency and loss severity for incurred but not reported losses are made based on historic data, trends, economic factors, and other statistical data in relation to paid claims, the reserve for reported losses unpaid, insurance in force statistics, and risk statistics.

CONTINGENCY RESERVE

The contingency reserve, as described in several statutes, is established and maintained for the purpose of protecting insureds against the effect of adverse economic cycles. The reserve is variously described as a premium reserve, or loss reserve, or is not specifically described. The annual contribution to the contingency reserve is deductible in the computation of the federal income tax liability as described in the chapter on “Federal Income Taxes.”

In most jurisdictions, the annual addition to the contingency reserve liability is 50% of earned premium. One jurisdiction requires that the reserve contribution be based upon the loan amount of outstanding mortgages insured or 50% of earned premiums, whichever is higher. In another jurisdiction, the annual addition applicable to the mortgage pool insurance business segment is based upon insured risk. Each annual addition to the contingency reserve must be maintained for 10 years before being released, except that releases are permitted (on a first-in, first-out basis) at an earlier date should actual losses exceed established percentages of earned premiums as set forth in the statutes.

There are two predominant practices being used to report the effect of contingency reserve transactions. “Practice One” is to report changes to the reserve in the income statement; “Practice Two” is to report changes as a direct adjustment to surplus.

Under Practice One, the liability for the contingency reserve is included in loss reserves and the net addition to (or deduction from) the contingency reserve liability is reported as a deduction from (or addition to) underwriting income in the income statement.

Under Practice Two, the liability for contingency reserves is reported as a separate line item among other liabilities. The net addition to (or deduction from) the contingency reserve liability is not recorded in the income statement, but rather it is reported as a direct adjustment to surplus.

Prior to computing financial ratios and results for an insurer: (1) underwriting income comparisons between insurers using the differing practices will require an adjustment to account for the differing treatments of additions to (or deductions from) the contingency reserve, and (2) as with the risk ratio calculation, the contingency reserve must be added to policyholders’ surplus. In addition, if appropriate, statutory net income should be adjusted for any federal income tax consequences arising from the purchase of tax and loss bonds (see Federal Income Taxes chapter). These adjustments may require information not found in the annual statement.
UNEARNED PREMIUMS

There are a variety of statutory accounting methods used by mortgage guaranty insurers to determine the earned and unearned portion of premiums written. The rate at which premiums are earned differs based on type of policy, the loan-to-value ratio of the mortgage and the policy term (single premium versus annual renewals).

Certain states dictate through statute or regulation a specific formula or table to be used for the above policy types. Special attention is placed on single premium (multiple year) policies and on the “excess risk” portion of the initial annual premium.

Renewal Premiums, Annual Premiums and Level Premiums

Renewal premiums and annual premiums on policies with a loan-to-value of 90% or less are earned on a monthly pro rata basis using the 13-month method (sometimes called the 1/24 method because 1/24 is earned in each of the first and last months, and 1/12 in each of the other 11 months). This method assumes that the effective dates of policies are spread evenly throughout the month and that the average date is the 15th.

Level premium policies are handled the same as the above. Thus, a three-year policy payable in three equal annual installments is booked the same way as the three successive one-year policies.

Annual Premiums on High-Risk Policies

In some jurisdictions, the portion of the first year’s premium which exceeds twice the annual renewal rate is earned on a deferred basis. (These premiums usually relate to mortgages with loan-to-value ratios in excess of 90%.)

Single Premiums

Single premiums are typically recognized on a deferred basis and then earned according to various statutorily mandated earnings curves.

LOSS AND LOSS ADJUSTMENT EXPENSES INCURRED

Mortgage guaranty insurance accounting differs from property insurance accounting in that if real estate is acquired, salvage value is recognized. If a property is in claims settlement, the difference between the cost of the property and its estimated net realizable value is recorded as loss expense at the date of acquisition. Further, in some jurisdictions, net additions to the contingency reserve are reported as part of incurred losses (see chapter on Contingency Reserve).

26. The Mortgage Guaranty Insurance Model Act provides the following guidance: (only pertinent excerpts included)

Section 16. Reserves

A. Unearned Premium Reserves

A mortgage guaranty insurance company shall compute and maintain an unearned premium reserve as set forth by regulation adopted by the commissioner of insurance.

B. Loss Reserve

A mortgage guaranty insurance company shall compute and maintain adequate case basis and other loss reserves which accurately reflect loss frequency and loss severity.
and shall include components for claims reported and for claims incurred but not reported, including estimated losses on:

(1) Insured loans which have resulted in the conveyance of property which remains unsold;

(2) Insured loans in the process of foreclosure;

(3) Insured loans in default for four (4) months or for any lesser period which is defined as default for such purposes in the policy provisions; and

(4) Insured leases in default for four (4) months or for any lesser period which is defined as default for such purposes in policy provisions.

C. Contingency Reserve

Each mortgage guaranty insurance company shall establish a contingency reserve out of net premium remaining (gross premiums less premiums returned to policyholders net of reinsurance) after establishment of the unearned premium reserve. The mortgage guaranty insurance company shall contribute to the contingency reserve an amount equal to fifty percent (50%) of such remaining unearned premiums. Contributions to the contingency reserve made during each calendar year shall be maintained for a period of one hundred and twenty months (120), except that withdrawals may be made by the company in any year in which the actual incurred losses exceed thirty-five percent (35%) of the corresponding earned premiums, and no such releases shall be made without prior approval by the commissioner of insurance of the insurance company's state of domicile.

If the coverage provided in this act exceeds the limitations set forth herein, the commissioner of insurance shall establish a rate formula factor that will produce a contingency reserve adequate for the added risk assumed. The face amount of an insured mortgage shall be computed before any reduction by the mortgage guaranty insurance company's election to limit its coverage to a portion of the entire indebtedness.

D. Reinsurance

Whenever a mortgage guaranty insurance company obtains reinsurance from an insurance company which is properly licensed to provide such reinsurance or from an appropriate governmental agency, the mortgage guaranty insurer and the reinsurer shall establish and maintain the reserves required in this chapter in appropriate proportions in relation to the risk retained by the original insurer and ceded to the assuming reinsurer so that the total reserves established shall not be less than the reserves required by this chapter.

E. Miscellaneous

(1) Whenever the laws of any other jurisdiction, in which a mortgage guaranty insurance company subject to the requirement of this act, is also licensed to transact mortgage guaranty insurance, require a larger unearned premium reserve or contingency reserve in the aggregate than that set forth herein, the establishment of such larger unearned premium reserve or contingency reserve in the aggregate shall be deemed to be in compliance with this chapter.

(2) Unearned premium reserves and contingency reserves shall be computed and maintained on risks insured after the effective date of this chapter as required by Sections 16A and 16C. Unearned premium reserves and contingency reserves on risks insured before the effective date of this chapter may be computed and maintained as required previously.
Section 17. Regulations

The commissioner shall have the authority to promulgate rules and regulations deemed necessary to effectively implement the requirements of this chapter.

Generally Accepted Accounting Principles
- No specific GAAP guidance obtained.

OTHER SOURCES OF INFORMATION

27. The AICPA Exposure Draft on mortgage guaranty insurance provides the following guidance.

Conclusions with respect to earning premium

19. Single premiums should be earned on a pro rata basis throughout the policy term, or on a declining basis if the amount of coverage significantly declines during the policy term. Annual premiums should be earned on the same basis. Level annual premiums should be earned on a pro rata basis over the policy term (usually one year). Additional first-year premiums on nonlevel policies, that is, the difference between first-year and level renewal premiums, should be deferred and amortized to income over the anticipated premium-paying period of the policies in relation to total anticipated premium receipts excluding the additional first-year premiums. If the dollar amount of coverage significantly declines during the anticipated premium-paying period, the additional first-year premium should be amortized to income in relation to anticipated coverage. If the initial renewal premium rate is higher than subsequent renewal premium rates, the excess premiums should be deferred and amortized to income over the remaining anticipated premium paying period of the policies in the same manner as the additional first-year premiums (this does not apply to policies with reduced premiums in later years, such as the tenth year or later). Level renewal premiums and the portion of the first-year premium equal to the level renewal premium should be earned on a pro rata basis over the policy term (generally one year). When significant differences between anticipated and actual renewal premiums occur, the predetermined amortization of additional first-year premiums should be adjusted to reflect actual experience.

Conclusions with respect to premium deficiencies

36. When anticipated losses and loss adjustment expenses, maintenance expenses and unamortized deferred acquisition costs exceed unearned premiums and estimated renewal premiums on existing policies, a provision for the anticipated premium deficiency should be provided. Premium deficiencies should be determined by reasonable groupings of business based on line of business or geographical area. (Premium deficiencies should be recognized by writing off any unamortized deferred acquisition costs to the extent required. If the deficiencies are more than the unamortized deferred acquisition costs, a separate liability should be provided for the excess deficiency).

37. In addition, companies that consider anticipated investment income in computing premium deficiencies should disclose the fact in their financial statements, together with the effects on the financial statements.

Conclusions with respect to recording claims

49. Losses should be accrued as of the initial default date, however, if a company can demonstrate that another date is more appropriate, such as 60 or 90 days after the initial default losses may be accrued as of that date.

50. In addition, companies that discount loss or loss adjustment expense reserves (see paragraphs 56 through 59) should disclose that fact in their financial statements, together with the effects on the financial statements.
51. No conclusion has been reached regarding whether loss reserves should be discounted; that is, whether the time value of money should be considered in determining loss reserves. This issue, as it applies to all insurance companies, is being considered separately by the AICPA Insurance Companies Committee.

RELEVANT LITERATURE

Statutory Accounting
- Accounting Practices and Procedures Manual for Property and Casualty Insurers, Appendix A
- The Mortgage Guaranty Insurance Model Act
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 22—Leases
- Issue Paper No. 53—Property Casualty Contracts - Premiums
- Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 65—Property and Casualty Contracts
- Issue Paper No. 71—Policy Acquisition Costs and Commissions
- Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

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

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

Other Sources of Information
- AICPA Exposure Draft on Mortgage Guaranty Insurance
- California Insurance Code §§ 12640.01 to 12640.18 (1961/1993)
- Wisconsin Administrative Code §§ 3.09 (1992)
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Statutory Issue Paper No. 89

Separate Accounts

STATUS
Finalized March 13, 2000

Type of Issue:
Life Specific

SUMMARY OF ISSUE


2. GAAP guidance for separate account contracts requires investments to be reported at market value except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets are generally reported in accordance with FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), as amended by FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114), FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115) and FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of (FAS 121). GAAP guidance for separate account contracts requires policy reserves or liabilities to be established using the balance that accrues to the benefit of the policyholder.

3. The purpose of this issue paper is to provide guidance on accounting and reporting for separate accounts in both the general account and separate account statement, consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Introduction

4. Separate accounts are used to fund variable life insurance, variable annuities, modified guaranteed annuities and modified guaranteed life insurance, or various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability. When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options.

5. Assets held in separate accounts are owned by the insurer. All investment income and realized and unrealized capital gains and losses from assets allocated to a separate account, net of related investment expenses, are generally reflected in the separate account and, except for modified guaranteed annuities, modified guaranteed life insurance, and separate accounts established and filed to provide guaranteed benefits, investment performance is generally not guaranteed by the insurer. Charges relating to contract guarantees, administration, and investment management are deducted from separate accounts.
General Account Reporting

6. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account and shall be accounted for as transactions of the general account.

7. For those separate account contracts classified as life contracts under Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force, premiums and annuity considerations shall be recorded as income in the Summary of Operations of the general account, and as transfers to premiums and considerations in the separate account statement. Deposit-type contracts shall be recorded in the general account in accordance with Issue Paper No. 52—Deposit-Type Contracts. Charges (e.g., fees associated with investment management, administration, and contract guarantees) assessed on the separate accounts, as well as the net gain from operations of the separate account shall be recorded as income in the Summary of Operations of the general account. Expenses relating to investment management, administration, and contract guarantees pertaining to separate account operations, as well as benefits and surrenders incurred on behalf of separate account contracts classified as life contracts, net transfers between separate accounts, commissions, and premium taxes (if any) shall be recorded as expenses in the Summary of Operations of the general account.

8. The general account shall include the total assets and liabilities, including transfers due or accrued, of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated. Changes in the surplus of the separate accounts business of an insurer, except for changes resulting from the net gain from operations of the separate account, shall be charged or credited directly to the unassigned funds (surplus) of the general account.

9. Where a variable annuity contract or variable life insurance contract contains a guaranteed minimum death benefit, any reserve liability for such death benefit provision shall be recorded and held in the general account based on the reserving guidance in paragraphs 24 and 25. Any differences between the benefit paid and the separate account asset value of the contract shall be charged against or credited to the general account in its net gain from operations.

10. Separate account surplus may not become negative. For example, for separate account contracts which have annuitized (i.e., contracts in the payout stage), lower than expected mortality on variable annuity contracts containing mortality guarantees may cause a deficiency in the investment funds underlying the contract reserves. Thus the general account incurs an expense and the separate account realizes revenue to cover this deficiency, if necessary. Conversely, excess funds from higher than expected mortality will result in mortality gains that are included in the Summary of Operations of the separate account and are ultimately recorded as equity in net income from separate account operations as discussed in paragraph 7.

11. For variable products, separate account surplus created through the use of the commissioners’ reserve valuation method (CRVM), commissioners’ annuity reserve valuation method (CARVM), or other reserving methods, shall be reported by the general account as an unsettled transfer from the separate account. The net change on such transfers shall be included as a part of the net gain from operations in the general account.

12. Surplus funds transferred from the general account to the separate account, commonly referred to as seed money, and earnings accumulated thereon shall be reported as surplus in the separate accounts until transferred or repatriated to the general account. The transfer of such funds between the separate account and the general account shall be reported as surplus contributed or withdrawn during the year.
13. If an Asset Valuation Reserve (AVR) is required for investments held by separate accounts, it is combined with the general account AVR and accounted for in the general account financial statements (see Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (Issue Paper No. 7)). The criteria for determining when an AVR is required for separate accounts are described in paragraph 17 of this issue paper.

**Separate Account Reporting**

14. The separate accounts annual statement is concerned with the flow of funds related to investment activities and obligations of the separate accounts and with the transfer of funds between the separate account and the general account. As a result, the separate account statement shall report only the assets, liabilities, and operations of the separate account and shall not include general account expenses related to investment management, administration, or contract guarantees pertaining to separate account operations which are recorded in the general account.

15. The separate account records premiums, considerations (net of loading for sales charges such as commissions and premium taxes) and receipts (other than for net investment income and realized capital gains and losses) as income transfers from the general account. Net investment income and realized and unrealized capital gains and losses relating to the investment operations of the separate account are recorded as income in the Summary of Operations. When the contract provides for such, expenses and taxes associated with the separate account investment operations shall be deducted in the determination of net investment income. Deposits and withdrawals on deposit-type contracts shall be recorded in the Summary of Operations. Benefits and surrenders, reserve transfers, policy loans, policyholder charges (e.g., fees associated with investment management, administration, and contract guarantees), and federal income taxes relating to the separate account are recorded as expense transfers to the general account in the Summary of Operations. The net change in aggregate reserves relating to separate account contracts is reported as an expense in the Summary of Operations.

16. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at market value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

**Separate Account AVR and IMR Reporting**

17. An AVR is generally required for separate accounts when the insurer, rather than the policyholder/contractholder, suffers the loss in the event of asset default or market value loss. An AVR is required unless:

   a. The asset default or market value risk is borne directly by the policyholders, or
   b. The regulatory authority for such separate accounts already explicitly provides for a reserve for asset default risk, where such reserves are essentially equivalent to the AVR.

18. Assets supporting traditional variable annuities and variable life insurance generally do not require an AVR because the policyholders/contractholders bear the risk of change in the value of the assets. However, an AVR is required for that portion of the assets representing the insurer’s equity interest in the investments of the separate account (e.g., seed money).

19. Assets supporting typical modified guaranteed contracts, market value adjusted contracts, and contracts with book value guarantees similar to contracts generally found in the general account do require an AVR because the insurer is responsible for credit related asset loss.
20. Certain separate accounts are also required to maintain an Interest Maintenance Reserve (IMR). The IMR requirements for investments held in separate accounts are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

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

22. If an IMR is required for investments held by separate accounts, it is kept separate from the general account IMR and accounted for in the separate accounts statement.

23. The AVR and IMR shall be calculated and reported in accordance with the Annual Statement Instructions.

Policy Reserves

24. Statutory policy reserves shall be established for all contractual obligations of the insurer arising out of the provisions of the insurance contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

25. The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendix A-250, A-270, A-255, A-585, A-588, A-620, A-820 A-822, and the actuarial guidelines found in Part 9 of the NAIC Financial Examiners Handbook. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at market.) Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

Other Liabilities

26. The separate account shall accrue as a liability, subject to contractual provisions, amounts payable, including, but not limited to:

- Charges for investment management, administration, and contract guarantees
- Investment expenses
- Investment taxes, licenses, and fees (Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate account but may be transferred to the general account for payment)
- Federal income taxes
- Unearned investment income
- Net transfer due to (from) the general account
- Remittances and items not allocated
- Payable for investments purchased
- Net adjustments in assets and liabilities due to foreign exchange rates
Seed Money

27. When a new separate account is initiated, the insurer may make a temporary transfer of surplus funds commonly referred to as seed money to the separate account. Such funds and earnings accumulated thereon shall be reported as surplus in the separate accounts statement until transferred or repatriated to the general account. The transfer of such funds to and from the separate account shall be reported as surplus contributed or withdrawn during the year.

Disclosures

28. The general account financial statement shall include a description of the general nature and characteristics of the various kinds of separate accounts business conducted by the company and included in the company’s Separate Accounts Statement. For each grouping (as detailed in paragraph 29), the following shall be disclosed:

a. Premiums, considerations or deposits received during the year;

b. Reserves by the valuation basis of the investments supporting the reserves at the financial statement date. List reserves for separate accounts whose assets are carried at market value separately from those whose assets are carried at amortized cost/book value;

c. Reserves by withdrawal characteristics, i.e., whether or not the separate account is subject to discretionary withdrawal or market value adjustment, or to withdrawal at book value with or without surrender charge;

d. Reserves for asset default risk, as described in paragraph 15 b., that are recorded in lieu of AVR.

29. Separate accounts shall be addressed in the following groupings (which are the same as those used for risk-based capital):

a. Separate Accounts with Guarantees:

i. Indexed separate accounts, which are invested to mirror an established index which is the basis of the guarantee;

ii. Nonindexed separate accounts, with reserve interest rate at no greater than 4% and/or fund long-term interest guarantee in excess of a year that does not exceed 4%;

iii. Nonindexed separate accounts, with reserve interest rate at greater than 4% and/or fund long-term interest guarantee in excess of a year that exceeds 4%.

b. Nonguaranteed Separate Accounts—Variable separate accounts, where the benefit is determined by the performance and/or market value of the investments held in the separate account. Include variable accounts with incidental risks, nominal expense, and minimum death benefit guarantees.

30. Provide a reconciliation of the amount reported as transfers to and from separate accounts in the Summary of Operations of the separate accounts statement and the amount reported as net transfers to or from separate accounts in the Summary of Operations of the general accounts statement.
DISCUSSION

Statutory Guidance

31. Consistent with Issue Paper No. 7, this issue paper adopts current statutory guidance for AVR and IMR for Life and Accident and Health insurance companies.

32. The statutory accounting principles outlined in the conclusion above regarding accounting and reporting for separate account life and annuity contracts are consistent with current statutory accounting, except for separate account deposit-type contracts which shall be accounted for consistent with the guidance in Issue Paper No. 52—Deposit-Type Contracts. The statutory accounting principles outlined in the conclusion above are consistent with the Statement of Concepts which states:

Conservatism

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management’s accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

Consistency

The regulators’ need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Recognition

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).
GAAP Guidance

33. In Issue Paper No. 7, Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities, 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, the GAAP guidance (principally, 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 115, FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts, and AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises) related to insurance contracts and separate account assets and liabilities was rejected for the reasons set forth therein.

Drafting Notes/Comments
- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- This issue paper references the Purposes and Procedures Manual of the 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. 56 references the Annual Statement Instructions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)

Statutory Accounting

34. The Life/A&H Accounting Practices and Procedures Manual, Chapter 25, Separate Accounts, provides the following guidance with respect to separate accounts:

SEPARATE ACCOUNTS

A life insurance company is authorized by state statutes to establish separate accounts and to allocate thereto, pursuant to agreements, amounts paid to it. Separate accounts may be used:

1. to provide for annuities, whether ultimately payable in guaranteed fixed amounts or variable amounts or both;

2. to provide life insurance where the benefits, premiums, or both, are payable on a variable basis and for which the reserves vary according to the investment experience of the underlying separate account;

3. to accumulate funds which are intended to be applied at some later time to provide life insurance, whether fixed or variable or both; or

4. to accumulate, or hold in a separate account, proceeds applied under settlement or dividend options.

All investment income and capital gains and losses (whether or not realized) from assets allocated to a separate account are, in accordance with applicable agreements, credited to or charged against the separate account policyholders. Investment performance is generally not guaranteed by the insurance company.

Assets allocated to separate accounts are owned by the insurer and the insurer is not a trustee by reason of the separate accounts. However, if permitted or required by state law, a separate agreement may provide that the portion of the assets of the separate account equal to the
reserves and other contract liabilities of the separate account shall not be chargeable with liabilities arising out of any other business of the insurer.

State statutes generally provide that amounts allocated to a separate account and accumulations on those amounts may be invested and reinvested without regard to any requirements or limitations imposed upon an insurer by the investment statutes which apply to insurers generally.

Some statutes provide that to the extent that the insurer’s reserve liability, with regard to benefits guaranteed as to dollar amounts and duration and funds guaranteed as to principle amount or stated rate of interest, is maintained in a separate account, a portion of the assets of the account at least equal to the reserve liability with regard to these benefits shall be invested in accordance with the investment statutes of the domiciliary state. These assets shall be reported separately and valued in accordance with the rules otherwise applicable to the insurer generally.

Assets allocated to a separate account, other than those provided for guaranteed benefits as described above, are valued at their market value on the date of valuation, or if there is no readily available market, then in accordance with the applicable contract.

The reserve or liability under a contract with a separate account provision is usually determined on the basis of the market value of the assets in the separate account.

Separate accounts may be used to fund individual variable life insurance, individual variable annuities, group variable life insurance, group variable annuities and various group contracts under pension or other employee benefit plans where funds are held in a separate account essentially as a liability. The financial experience on these separate accounts is reported in the annual statement of separate accounts business.

Relationships of the Separate Accounts Annual Statement and the Life and Accident and Health Annual Statement

Accounting for separate account business involves both the general account of a company and the separate accounts. The separate accounts annual statement is concerned primarily with the investment activities of the separate accounts and with the flow of funds from and to the general account. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account fund and are accounted for as transactions of the general account; the expenses incurred on account of these functions are reported in the life and accident and health annual statement. Thus, premiums and considerations and benefit payments on separate accounts business are reported respectively in the premiums and annuity considerations exhibit and the policy contract claims exhibit of the life and accident and health statement. Similarly the policy exhibit and the exhibit of annuities and supplementary contracts with life contingencies in the life and accident and health statement includes variable annuity contracts.

Expenses incurred on contracts with separate accounts (other than direct investment expenses) are generally reported in the general account. Fees related to these expenses are charged to the separate accounts policyholders. Federal income taxes and taxes incurred on separate account investments are reported in the separate account statement, but other taxes, i.e., taxes on consideration, are reported in the general account. Where a variable annuity contract contains a guaranteed minimum benefit such as return of consideration paid on death within a specified period, any excess of the benefit paid over the separate account asset value of the contract would customarily be a charge against the general account. Any reserve liability for such death benefit provisions is normally carried in the general account.

Under a variable annuity contract containing mortality guarantees which are reserved in the general account, when lighter than expected mortality causes a deficiency in the investment funds underlying the contract reserves, the general account must transfer funds to the separate account. Conversely, excess funds form higher than expected mortality are transferred to the
general account. As a general rule, the total statement value of the assets held in a separate account must be equal to (never less than) the total separate account reserve liability of the contracts participating in the separate account. If mortality gains are allowed to accumulate in the separate account, these accumulations may be reported as surplus.

Overview of the Flow of Funds and Accounting

Gross purchase payments received are reported in the life and accident and health statement. In the case of a variable life or variable annuity contract, the net purchase payment is transferred immediately to the separate account. In most cases, the purchase payment transferred will be net (gross minus loading).

If a net purchase payment on a variable annuity is not accounted for as consideration received, it should be transferred to the separate account as an “annuity deposit” or “purchase payment reserve” (or similar term). The loading might be treated as a consideration for accounting purposes. At such time as the accumulation is to be applied to purchase an annuity or supplementary contract, the entire accumulation (net purchase payments plus investment income) is transferred to the general account to be accounted for as consideration received. Appropriate taxes on the total amount of such consideration (including all accumulated investment income) are deducted before the remaining funds are either transferred back to the separate account as consideration for a variable annuity or supplementary contract or used to buy a fixed annuity or supplementary contract in the general account. The return of the fund or surrender or death prior to maturity is generally reported as a return of purchase payments. This is the equivalent of the redemption by the issuer of shares in a mutual fund, which a variable annuity in the accumulation stage closely resembles.

In the employee benefit area, separate accounts may be used to fund part or all of unallocated pension funds during the accumulation phase and group variable annuities in the payout phase. Amounts of consideration or purchase payments are received from the employer through the general account and transferred to the separate account after deducting any loading for expenses, etc. Funds withdrawn for the purchase of fixed or variable annuities are transferred to the general account where they are reported as considerations received. Applicable taxes are deducted prior to purchase of an annuity for a retiring employee.

Under certain arrangements, employee benefit funds may be put into a separate account to be accumulated until withdrawn to be used for various purposes. Such funds would not be reported as income; amounts transferred from the general account are reported net of amount returned.

Generally, considerations, purchase payments, deposits, etc., received by a separate account are recorded on a cash basis.

Life and annuity benefits and payments on supplementary contracts are paid through the general account with funds transferred from the separate account. The liability for any benefits transferred but unpaid at year-end would be carried by the general account.

Some variable annuity contracts, during the accumulation period, permit the contract holder to transfer funds between the separate account and the general account. In order to avoid inflating the income reported in either or both accounts, special provision is made for transferring these reserves between the general account and the separate accounts.

Individual variable annuity contracts usually contain guarantees for mortality and expense assumptions. Charges for these guarantees, and for administrative and investment management expenses, are usually expressed as an annual percentage of the asset value of the contract and may also include an amount per contract. Such charges may be calculated and deducted from the separate account on a daily, weekly, or monthly basis—generally the same interval at which the separate account is valued. Group contracts with separate account provisions may have similar arrangements.
Charges, when deducted from the separate account asset values, are usually transferred to the general account. Charges deducted but not yet transferred are usually carried as a liability in the separate accounts statement. Some companies prefer to accumulate the mortality and expense guarantee charges in the separate account as surplus.

Investment expenses incurred may be payable directly by the separate accounts or may be incurred by the general account to be reimbursed by the separate accounts. Investment expenses incurred by the general account on behalf of the separate accounts may be reported in the life and accident and health statement. These investment expenses may be deducted from this statement, on a line by line basis, and entered in the same way in the separate accounts statement; or they may be deducted as a single negative item in the life and accident and health statement and entered as a summary item in the separate accounts statement.

Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate accounts but may be transferred to the general account for payment. Federal income taxes are not paid directly by the separate accounts. The amount of federal income tax estimated as incurred is transferred to the general account.

A reserve for future federal income taxes is provided for in the separate accounts statement. The purpose of this item is to recognize that the amount of capital gains credited to contract holders at any time is the net after deducting capital gains taxes which would be payable under the assumption that all assets were disposed of at that point in time. This deduction is reflected in the increase in the liability item, “Reserves for future federal income taxes.” Note that a decrease in unrealized capital gains would cause a decrease in this reserve.

When a new separate account is initiated, the company may make a temporary transfer of surplus funds commonly referred to as “seed money” to the separate account. Such funds are reported as surplus in the separate accounts statement and the transfer of such funds to and from the separate account would be reported as surplus contributed or withdrawn during the year. The rules and regulations of various states restrict the sale, exchange, or transfer of assets between the general and separate accounts.

Separate accounts, as reported in the statement blank, would normally not develop a gain from operations because (a) gains or losses arising from mortality and expenses are reflected in the general account; (b) investment expenses and taxes are deducted from investment gains and losses; and (c) investment gains and losses after expenses and taxes are absorbed in the increase in reserve liabilities. A gain from operations could arise from earnings on contributed surplus maintained in a separate account or when a company does not transfer mortality and expense guarantee charges out of the separate accounts. Note that a separate account surplus can never be permitted to become negative.

Mortality gains and losses can be handled in either of two ways.

1. If the separate accounts are being reported on a zero gain from operations basis, then any net gain from mortality should be transferred to the general account, or, if a loss, a transfer of an offset amount should be made from the general account. In either case, on the aggregate write-in lines under “Other transfers from the separate accounts” in the Summary of Operations page of the separate accounts statement, appropriately captioned, e.g., “Other transfers (net),” may be used. An offset to a mortality loss would be a negative entry.

2. If mortality gains or losses are to be permitted to flow through to the gain from operations and the surplus account is to be kept at zero, then a counterbalancing entry must appear in the surplus account. Since surplus in a separate account cannot be permitted to be negative, a counterbalancing contribution to surplus from the general account must be made whenever surplus would otherwise become negative.
The analysis of increase in reserves illustrates how the year-end reserves reported are developed from the operations of the separate account. It follows in a general way the corresponding analysis in the life and accident and health statement.

Separate Account Reporting in the Life and Accident and Health Statement

Transfer transactions affect both the life and accident and health and the separate accounts statements but to avoid duplicate detailed reporting, and also to avoid complicating the life and accident and health statement, the details of the transfer are shown only in the separate accounts statement. Aggregate transfer items are netted and shown in the inserts on the liabilities page and in the Reconciliation of Cash and Invested Assets in the separate accounts statement. These same net totals would be included as single line entries on appropriate pages of the life and accident and health statement.

The asset page of the life and accident and health statement provides for the entry of the totals from the asset page of the separate accounts statements. The liabilities page of the life and accident and health statement provides for two entries from the separate accounts statements. The first entry shows the amount of transfers to the separate accounts due or accrued. This item is entered on a net basis so that if there is an amount due from the separate accounts to the general accounts, the net of the two will be entered as a negative item. The reason for this treatment is that a more normal treatment, under which an amount due the general account from the separate account is entered as an asset in the life and accident and health statement, would inflate both the assets and the liabilities totals of the life and accident and health annual statement. The second entry on the liabilities page of the life and accident and health statement is for the total liabilities entry from the separate accounts statement.

The Summary of Operations and Analysis of Operations by Lines of Business of the life statement provide for entry of net transfers to separate accounts—there is no one source for this figure in the separate accounts statement. Items relating to separate accounts may also appear as direct entries to surplus.

35. The Separate Accounts Annual Statement Blank Instructions provide the following guidance with respect to separate accounts:

GENERAL

The instructions for completing the general account are to be followed to the extent applicable. This supplement provides additional instructions that are unique to the Separate Accounts Blank as well as some that differ from those for the Life and Accident and Health Blank. Where there is a conflict with the Life Blank’s instructions use these instructions. The reporting date must be plainly written or stamped at the top of all pages, exhibits and schedules (and duplicate schedules) and also upon all inserted schedules and loose sheets.

The separate accounts statement reports only the operations of the separate accounts themselves. It assumes that the administration of the contracts is reflected in the general account statement—hence, administrative expense does not appear in the Separate Accounts Statement, premiums and considerations are net of loading, and the expenses and taxes are those associated with the separate account investment operations.

Receipts other than income from investments are handled as a transfer from the general account. Similarly, amounts providing for the payment of benefits, including surrender benefits and various other payments, appear as transfers from the separate account to the general account. When eventually paid, these items are reported in the general account statement. The assets and liabilities are strictly those which arise from the operations of the separate accounts themselves, i.e., policy and contract reserves and items related to the making of investments, including investment expenses and taxes due or accrued. Unpaid transfers due the general account, such as surplus, contractual benefits, or contractual charges, would also appear on the liability page.
36. The June 5, 1995 minutes of the Separate Accounts Working Group of the Accounting Practices and Procedures (EX4) Task Force provide the following guidance with respect to separate accounts:

1. Accounting for Separate Account Surplus

Peter Storms (Arthur Andersen) provided a summary of the work accomplished to date relative to accounting for separate account surplus. Mr. Storms noted that the interested parties group continues to support its original recommendation.

Tomoko Stock (Calif.) stated that California opposes the recommendation of the interested parties group. Specifically, they oppose the reporting of fee income, generated through the use of Commissioners Annuity Reserve Valuation Method (CARVM), being allowed to flow through the general account’s income statement on an accrual basis. Ms. Stock suggested that this treatment of fee income inflates current income and has a potential impact on stockholder dividends. The California position is to recognize the income as it is realized.

Jack Gies (Conn.) noted that surplus created through the use of CARVM is a book item, not a cash item. He also noted that the income earned from separate account fees is fairly certain to be realized either through mortality and expense charges or through surrender charges.

Working group members noted that the accounting treatment being proposed assumes that CARVM is being applied in an accurate and prudent manner.

Alan Close (Northwestern Mutual Life) stated that his recommendation included a different balance sheet presentation from that recommended by the interested parties group, with an approach that stresses the appropriate measure of assets and liabilities. He noted, however, that his recommendation supported the income statement presentation recommended by the interested parties group.

Bill Carroll (American Council of Life Insurance—ACLI) noted that the ACLI’s committee on statutory accounting met in May 1995 and voted to support the recommendation of the interested parties.

After being duly moved and seconded, the working group voted to adopt the accounting treatment for separate account surplus which requires that separate account surplus created through the use of CARVM be recorded as an unsettled transfer from the separate accounts; that separate account seed money and earnings accumulated thereon, be reported in the separate accounts until repatriated; and that the net gain from separate accounts operations be included in the general account summary of operations. Blank proposals to effect this accounting treatment will be prepared for submission prior to July 1, 1995.

Ms. Stock noted that the adopted accounting treatment will include parenthetical entries on the balance sheet to specifically identify amounts in the transfer account that are related to the use of CARVM.

The working group noted, that in adopting this accounting treatment, it will be necessary for the Risk-Based Capital Task Force to revise the life risk-based capital report to include the separate accounts transfer balance with the separate accounts surplus when applying the risk-based capital charge. Blaine Shepherd (Minn.) stated that he would report this issue to the Risk-Based Capital Task Force.

37. Chapter 16, *Asset Valuation Reserve and Interest Maintenance Reserve*, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies states the instructions for calculating the AVR and IMR are contained in the Annual Statement Instructions for Life and Accident and Health Insurance Companies.
38. Section 6. *Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures Manual of the NAIC Securities Valuation Office* contains the following excerpts (note that this is not quoted in its entirety):

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

- The Default Component--
  - (i) Other Than Mortgage Subcomponent
  - (ii) The Mortgage Subcomponent

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

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

The current year’s IMR is equal to:

\[
\text{The beginning balance} \\
+ \text{the realized capital gains (losses) net of tax attributed to interest rate changes} \\
+ \text{the realized liability gains (losses) net of tax attributed to interest rate changes} \\
- \text{an amortization amount}
\]

(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. With respect to Class One Bond Mutual Funds, “realized capital gains and (losses)” include any capital gains and losses realized by the Company, whether from sale of the Fund or capital gains distributions by the Fund. However, where the gain on a convertible bond or preferred stock sold while “in the money” is included in IMR, the expected maturity date is defined as the next conversion date. “In the money” is defined to mean that the number of shares available currently or at next conversion date, multiplied by their current market price, is greater than the statement value of the convertible asset. However, for a convertible bond or convertible preferred stock purchased while its conversion value exceeds its
par value, any gain or loss realized from its sale before conversion must be excluded from the IMR and included in the AVR. Conversion value is defined to mean the number of shares available currently or at next conversion date, multiplied by the stock’s current market price. The holding period is defined as the period from the date of purchase to the date of sale. For end of period classification, the most recent available rating should be used. For debt securities acquired before January 1, 1991, the debt security’s rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security’s gain or loss should not be included in this reserve if the debt security rating was ever a “6” during the holding period.

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

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

For Class One Bond Mutual Funds, the holding period is defined as one calendar year to expected maturity.

Determination of IMR gain or loss on multiple lots of the same securities should follow the underlying accounting treatment in determining the gain or loss. Thus, the rating classifications, on a purchase lot basis, should be compared to the rating classification at the end of the holding period to determine IMR or AVR gain or loss.

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

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

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

Realized gains and losses, net of capital gains tax, on derivative investments arising out of transactions entered into solely for the purpose of altering the interest rate characteristics of the company’s assets and/or liabilities should be allocated to the IMR and amortized into income over the remaining life of the assets or liabilities associated with the derivative instruments. Gains or (losses) on dollar repurchase agreements that are traded for the fee have no IMR (or AVR) impact because they are treated as financings.

If during the course of the year, the SVO removes the classification of “class one” from a Class One Bond Mutual Fund, the company shall not report capital gains or (losses) on this schedule. Any such removal of the “class one” classification will cause the Fund to be reported as common stock on the applicable schedules.
(b) Liability gains/(losses) Subject to IMR Amortization

1) Reinsurance -

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

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

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

3. the transaction was completed in the current year.

A company may elect to use a lower materiality threshold than the 5% specified in Item 1 above provided that such election is applied consistently to all transactions subsequent to the election, and the election is conveyed to the Insurance Department of the state of domicile. Once a threshold is elected, it can only be changed with the prior approval of the Insurance Department of the state of domicile.

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

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

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

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

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

2.) Market Value Adjustments

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

(d) Amortization into income:

There are two acceptable methods for accumulating and calculating the amortization schedule. A company can select either the seriatim method or the grouped method for calculating IMR amortization. Although a company is not precluded from changing methods on a prospective
basis, the overriding consideration is the reasonableness of the amortization. However, once a
method is selected for a particular year’s capital gains, the amortization is locked in and cannot
be changed (at least not without the specific approval of the commissioner).

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

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

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

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

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

0 calendar years to expected maturity,
1 calendar year to expected maturity,
2 to 5 calendar years to expected maturity,
6 to 10 calendar years to expected maturity,
11 to 15 calendar years to expected maturity,
16 to 20 calendar years to expected maturity,
21 to 25 calendar years to expected maturity,
over 25 calendar years to expected maturity.

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

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

For fixed income instruments with fixed contractual repayment dates and amounts (including
bonds, preferred stock, callable or convertible bonds and preferreds), the expected maturity
is defined as the contractual retirement date that produces the lowest amortization value for
Annual Statement purposes (lowest internal rate of return or “yield to worst”). Potential
retirement dates include all possible call dates, and the contractual maturity date where a
convertible bond or convertible preferred stock is sold while its conversion value exceeds it
statement value and the gain is included in IMR, the expected maturity date is defined as the
next conversion date. Conversion value is defined to mean the number of shares of common
stock available currently or at the next conversion date, multiplied by the stock’s current
market price. When the instrument’s contractual terms include scheduled sinking fund
payments of fixed amounts, an additional calculation of yield to average life should be
included in the analysis where average life is defined as the date at which the instrument is 50% repaid. For puttable instruments, where the exercise option rests with the investor, expected maturity is the put or maturity date that produces the highest internal rate of return. For Class One Bond Mutual Funds, use one calendar year to expected maturity. For perpetual instruments, the expected maturity is 30 years from the current date.

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

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

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

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

- For fixed income investments, other than residential mortgages and residential mortgage pass-throughs, without a maturity date or sinking fund schedule, a maturity date 30 years from the current year should be used.
- For loan-backed bonds and other structured securities that are valued using currently anticipated prepayments use the remaining weighted average life of principal and interest payments consistent with the prepayment assumptions that would have been used to value the security had the security been repurchased at its sale price.

(e) Separate Accounts

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

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

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

(f) Negative IMR

A negative IMR balance may be recorded as a negative liability in either the general account or the separate accounts statements of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.
The following information is presented to assist in determining the proper accounting:

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

Rules:

a) If both balances are positive, then report each as a liability in its respective statement.

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

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

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

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

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

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

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

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

The Equity Component

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

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

(a) Calculation of the AVR:

The current year’s AVR by subcomponent is equal to:

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

(b) Realized Capital Gains and Losses:

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

A realized gain or loss on a debt security will be a credit related gain or loss if the debt security’s beginning NAIC/SVO rating changed by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991 the debt securities rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security gain or loss should always be included in this reserve if the bond rating was ever a “6” during the holding period. Determination of the AVR gain or loss on multiple lots of the same fixed income securities should follow the underlying accounting treatment in determining gain or loss. Thus, the rating classifications, on a purchase lot basis, should be compared to the rating classification at the end of the holding period to determine IMR or AVR gain or loss. Permanent impairment write-downs are treated as credit-related (losses).

Preferred stock that had an NAIC/SVO rating classification of “PSF-4”, “PSF-5”, “PSF-6”, “P-4”, “P-5” or “P-6” at any time during the holding period shall be reported as credit related gains and (losses) in the Asset Valuation Reserve.
However, for a convertible bond or preferred stock purchased while its conversion value exceeds its par value, any gain or loss realized from its sale before conversion must be included in the Equity Component of the AVR. Conversion Value is defined to mean the number of shares available currently or at next conversion date, multiplied by the stock’s current market price.

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

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

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

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

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

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

The gains or (losses) are to be reported net of applicable capital gains taxes as allocated by the company.

(c) Unrealized Capital Gains and Losses:

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

Unrealized gains or losses on hedging instruments should be included with the hedged instruments.

(d) Transfers Between Components:

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

If after the above transfers, the Equity or Default component is greater than total maximum for the component, the excess may be transferred to the other component or may be released to surplus.
If the balance before transfers of any of the four sub-components is negative, and the balance before transfers of its “sister” subcomponent within the same component is positive, the negative amount should be transferred to the “sister” sub-component to the extent that the transfer does not reduce the positive balance before transfers of the “sister” sub-component to less than 50% of its balance prior to the transfer.

No other transfers may be made without Commissioner approval. No transfers between the AVR and IMR are allowed.

(e) Annual Contribution:

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

The contribution rate times the difference between the subcomponent maximum amount and the accumulated balance. (Accumulated balance is shown on Page 49, Line 6 of the Annual Statement). This number will be positive when the maximum reserve exceeds the accumulated balance and negative when the accumulated balance is in excess of the maximum reserve.

(f) Contribution Rate:

The contribution rate is 20% per year.

(h) Voluntary Contribution to the Reserves:

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

39. The NAIC Annual Statement Instructions provide the following guidance (note that this is not quoted in its entirety):

INTEREST MAINTENANCE RESERVE

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

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

If an IMR is required for investments in the Separate Accounts Statement, it is kept separate from the General Account IMR and accounted for in the Separate Accounts Statement.

ASSET VALUATION RESERVE

Asset Valuation Reserve (AVR) requirements for investments reported in the Separate Accounts Statement are applied on an account by account basis. If an AVR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an AVR is not required for a separate account, none of the investments in that separate account are subject to the requirement (except to the extent that such investments represent the company's capital and surplus interest in those investments).
Whether or not an AVR is required for separate account assets depends primarily on whether the insurer or policyholder/contractholder suffers the loss in the event of asset default or market value loss. An important exception to this is when specific state regulation provides an alternative to the AVR.

An AVR is required for separate account investments unless:

1. The asset default or market value risk is essentially borne directly by the policyholders, or

2. The regulatory authority for such separate accounts already explicitly provides for establishment of a reserve for asset default risk where such reserves are essentially equivalent to the AVR.

For example, assets supporting traditional variable annuities, and variable life insurance do not require an AVR because the policyholders/contractholders bear the risk of change in the value of assets. However, an AVR is required for that portion representing the company’s equity interest in the investments of such a separate account, (seed money interest, for example). Assets supporting typical modified guaranteed contracts or market value adjusted contracts do require an AVR because the company is responsible for credit related asset loss. Another category of contracts requiring an AVR is contracts with book value guarantees similar to contracts generally found in the general account.

An example of the exception referred to in (2) above are contracts with market value separate accounts funding guaranteed benefits where state regulation provides alternatives to the AVR.

The following criteria are presented to assist in determining when an AVR or an IMR are required for investments in the Separate Accounts Statement:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Does Co. Suffer Asset Loss?</th>
<th>If Yes, Any Other Provision?</th>
<th>AVR*</th>
<th>IMR</th>
<th>Example Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>Market</td>
<td>No</td>
<td>--</td>
<td>No</td>
<td>No</td>
<td>Variable Annuity</td>
</tr>
<tr>
<td>Market</td>
<td>Market**</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Modified Gtd. Annuity</td>
</tr>
<tr>
<td>Market</td>
<td>Market</td>
<td>Yes</td>
<td>Yes</td>
<td>No***</td>
<td>No</td>
<td>MV S/A funding Gtd. Benefits</td>
</tr>
<tr>
<td>Book</td>
<td>Book</td>
<td>No</td>
<td>--</td>
<td>No</td>
<td>No</td>
<td>--</td>
</tr>
<tr>
<td>Book</td>
<td>Book</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>GIC in S/A</td>
</tr>
<tr>
<td>Book</td>
<td>Book</td>
<td>Yes</td>
<td>Yes</td>
<td>No***</td>
<td>Yes</td>
<td>--</td>
</tr>
</tbody>
</table>

* However, an AVR is required for that portion representing the company’s equity interest in the investments of such a separate account.

** But not less than adjusted cash surrender value.

*** You must establish an AVR reserve unless there is a statutory requirement for the equivalent of an AVR reserve for such products.
If an AVR is required for investments in the Separate Accounts Statement, it is combined with the General Account AVR and accounted for in the General Account Statement. Worksheets supporting the separate accounts portion of the reserve are included in the Separate Accounts Statement.

When the AVR Default Component covers assets valued at market, use one of the following two methods (applied consistently by separate account) to determine when a gain or loss (net of capital gains tax) is credited or charged to the AVR:

1. A gain or (loss) is recorded as for the general account rules, i.e., upon sale of an asset which has changed more than one rating category or upon asset default. Once an asset is in default, all subsequent market value changes are reflected in the AVR, or

2. A similar procedure to Method 1 above is followed but, additionally, a gain or (loss) is recorded whenever an asset held changes by more than one rating category. As there might be more than one such event for a particular asset, e.g., a two rating downgrade followed by subsequent sale of the asset, the amount charged the AVR is net of any prior amounts charged for that asset.

When an AVR is required for the company’s equity or capital and surplus interest in the investments of a particular separate account that does not otherwise require an AVR, the AVR requirement is based on the company’s equity interest as of the statement date, expressed as a percent of total assets of the particular separate account. Once the equity interest percentage has been determined, it is applied to the realized and unrealized capital gains and losses and the investments of that particular separate account to determine the amounts to be included in the separate accounts data used for development of the current AVR. If the company’s equity interest in all such separate accounts is less than 1/10th of 1% of the company’s total admitted assets, the equity interest in the investments of such separate accounts is exempt from AVR requirements.

Most state regulations refer to the literature of the NAIC for guidance on the calculation of AVR and IMR. An example is the Texas Administration Code, Title 28 - Insurance, Chapter 7, Corporate and Finance, which states:

(4) Asset valuation reserve (AVR) -- A reserve applied to the specific risk characteristics of all the invested asset categories except cash, policy loans, premium notes, collateral loans, and income receivables. Asset valuation reserves shall be calculated as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

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

Generally Accepted Accounting Principles

41. FAS 60 provides the following guidance related to separate accounts:

Separate Accounts

53. Separate accounts represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding fixed-benefit or variable annuity contracts, pension plans, and
similar activities. The contract holder generally assumes the investment risk, and the insurance enterprise receives a fee for investment management, certain administrative expenses, and mortality and expense risks assumed.

54. Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45-51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise.

The reporting requirements of FAS 60, paragraphs 45-51, have been amended by FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, FAS 97, FAS 114, FAS 115, and FAS 121.

42. AVR and IMR are not addressed in current GAAP literature.

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

**Reporting of Realized Investment Gains and Losses of Investments**

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

**OTHER SOURCES OF INFORMATION**

44. The draft discussion material from previous Life Codification projects contains the following excerpts:

**Chapter 16A - Interest Maintenance Reserve**

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

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

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

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

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

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 10, 16 and 25
- NAIC Annual Statement Instructions
- Minutes to the Separate Accounts Working Group Meeting of June 5, 1995
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force
- Issue Paper No. 5—Life Contracts
- Issue Paper No. 52—Deposit-Type Contracts

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
- FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments
- FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts
- FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of
- AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises

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

Other Sources of Information
- Draft discussion material from previous Life Codification projects, Chapter 16A, Interest Maintenance Reserve, and Chapter 16B, Asset Valuation Reserve
Statutory Issue Paper No. 90

Nonadmitted Assets

STATUS
FINALIZED MARCH 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. As described in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets (Issue Paper No. 4), one of the cornerstones of statutory accounting is the use of nonadmitted assets. The use of nonadmitted assets is consistent with the recognition concept in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Current statutory accounting guidance for nonadmitted assets is provided throughout the Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies and Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals).

3. The purpose of this issue paper is to establish statutory accounting principles for nonadmitted assets which are not specifically addressed in other issue papers, consistent with the Statement of Concepts and Issue Paper No. 4.

SUMMARY CONCLUSION

4. The definition and accounting treatment for nonadmitted assets is outlined in paragraph 3 of Issue Paper No. 4 as follows:

   As stated in the Statement of Concepts, “The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet”, and are, therefore, considered nonadmitted.

   Issue Paper No. 4 defines nonadmitted assets as follows:

   An asset meeting the criteria in paragraph 2 above which is accorded limited or no value in statutory reporting and is one which is:

   a. Specifically identified within the Codification as a nonadmitted asset or

   b. Not specifically identified within the Codification as an admitted asset.

   If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Codification. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires.
5. This paper shall not be considered an all-inclusive list of nonadmitted assets. Certain admitted assets and nonadmitted assets are addressed in other issue papers. Assets not addressed in specific issue papers are nonadmitted until specifically authorized.

6. Consistent with paragraph 4, the following assets shall be nonadmitted and shall be reported in accordance with Issue Paper No. 4.

**Deposits in Suspended Depositories**

7. Amounts on deposit with suspended depositories may not be fully recoverable. Any amounts not reasonably expected to be recovered shall be written off in accordance with Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). Amounts in excess of that written off shall be nonadmitted as they are not available to satisfy obligations to policyholders.

**Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments**

8. In accordance with Issue Paper No. 5, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized as there are no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations.

**Loans on Personal Security, Cash Advances To, Or In The Hands Of, Officers Or Agents And Travel Advances**

9. In accordance with Issue Paper No. 5, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off typically are unsecured and as such have no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Some of these items may also be considered prepaid expenses which, per Issue Paper No. 29—Prepaid Expenses (Excluding Deferred Policy Acquisition Costs and Other Underwriting Expenses, Income Taxes, and Guaranty Fund Assessments), are nonadmitted.

**All “Non-Bankable” Checks**

10. Examples of “non-bankable” checks are NSF (non-sufficient funds) checks, post dated checks, or checks for which payment has been stopped. Although these checks may still maintain probable future benefits (and thus meet the definition of assets), at the date on which they are non-bankable they are not available for policyholder obligations and shall be nonadmitted until the uncertainty related to the probable future benefit is resolved and the checks are converted to available funds.

**Trade Names And Other Intangible Assets**

11. These assets, by their nature, are not readily marketable and available to satisfy policyholder obligations and shall be nonadmitted.

**Automobiles, Airplanes and Other Vehicles**

12. Automobiles, airplanes and other vehicles meet the definition of assets established in Issue Paper No. 4. However, they are not readily available to satisfy policyholder obligations and as a result the undepreciated portion shall be nonadmitted. The accounting for these assets shall be consistent with the accounting for equipment provided in Issue Paper No. 19—Furniture, Fixtures and Equipment.
Company’s Stock as Collateral for Loan

13. When a reporting entity lends money and accepts its own stock as collateral for the loan, it shall report the amount of the loan receivable and any related accrued interest on the loan as a nonadmitted asset. The asset is nonadmitted as the collateral could not be used to satisfy the obligation in the event of default.

DISCUSSION

14. For those items specifically addressed within this issue paper the principles established are consistent with current statutory accounting practices except as follows:

   a. With respect to the principles outlined in paragraphs 7, 8 and 9, current statutory accounting nonadmits a portion of or the entire amount of the asset. The conclusion above requires the write-off of the portion not expected to be recoverable in accordance with Issue Paper No. 5 with any remaining amounts being nonadmitted as outlined above.

   b. In relation to paragraph 7, such treatment is consistent with current statutory accounting for life and accident and health insurance companies but is a change for property and casualty insurance companies as current statutory accounting requires only “the amounts on deposit in excess of what reasonably can be estimated as recoverable” to be nonadmitted.

   c. Paragraphs 12 and 13 identify assets that are to be treated as nonadmitted assets. These assets are generally recognized as nonadmitted assets in current statutory accounting practice although they were not previously specifically stated as such.

15. The statutory accounting principles outlined above are consistent with the conservatism and recognition concepts in the Statement of Concepts, current statutory accounting guidance and Issue Paper No. 4.

Conservatism

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency.

Recognition

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

Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

16. Statutory treatment differs from GAAP in that GAAP does not have a concept of nonadmitted assets and would recognize the items addressed above as assets to the extent they remain collectible or recoverable.
Drafting Notes/Comments
- Issue Paper No. 5 discusses and outlines the appropriate treatment for the impairment of assets.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

17. The Life/A&H and P&C Accounting Practices and Procedures Manuals, page iv and page v, respectively, provide the following guidance:

ASSETS

paragraph 1

Because of the conservatism intrinsic to insurance accounting, certain assets may be accorded limited or no value in statutory reporting, i.e., nonadmitted assets.

18. Chapter 9, Nonadmitted Assets, of the P&C Accounting Practices and Procedures Manual provides guidance as outlined below. Many of the items given as examples in Chapter 9 have been addressed in separate issue papers and therefore are not addressed in the conclusion of this issue paper. Additionally, the accounting treatment for such items addressed in separate issue papers may no longer be consistent with the accounting treatment outlined in Chapter 9.

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

The following are examples of nonadmitted assets:

1. Excess of Book Value over Market Value of Securities: In keeping with the concept of presenting the balance sheet on a conservative basis, the unrealized loss on stocks and impaired bonds reduces the admitted asset value on the annual statement.

2. Deposits in Suspended Depositories (less the estimated recoverable amount): The amounts on deposit in excess of what reasonably can be estimated as recoverable are nonadmitted.

3. Agents’ Balances or Uncollected Premiums Over Three Months Due: The statutes of most states require that agents’ balances or uncollected premiums over three months due be nonadmitted because of the uncertainty of collection. The over three months rule does not apply to ceded reinsurance premiums payable due from solvent insurance companies provided the assuming insurer maintains sufficient reserves as to the ceding insurer to apply the principles of offset accounting or the ceding insurer is licensed and in good standing in the state of the assuming insurer’s domicile.

4. Future installments on all policies for which one or more installments are over three months due.

5. Accrued retrospective premiums from any person for whom any agents’ balances or uncollected premiums are classified as nonadmitted.
6. Bills Receivable, Taken for Premiums: Bills or notes receivable are used as methods of financing premiums usually in states where installment premiums are not permitted or customary. If any portion of a bill or note receivable is unpaid past the due date of the installment, the entire bill or note is classified as nonadmitted. Also, on bills or notes not past due, the excess of the balance due over the unearned premium on the underlying policy or policies is classified as a nonadmitted asset. To the extent bills receivable are taken for premium for retrospectively rated policies, such bills must meet the same criteria required of accrued retrospective premiums to be reported as an admitted asset.

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

8. Equipment, Furniture and Supplies: The company may record furniture and equipment as a ledger asset, depreciate it, and nonadmit it in the exhibit of assets in the statutory financial statements, or the company may expense the furniture and equipment when it is purchased. Supplies are normally expensed when purchased.

9. Bills Receivable, Not Taken for Premiums: All bills or notes receivable - except those from an insured for premiums, or those fully secured by collateral- are classified as nonadmitted.

10. Loans on Personal Security: Loans on personal security by definition are not properly secured by collateral. Therefore, they are classified as nonadmitted.

11. Prepaid Expenses.

12. Cash Advances To, or In the Hands Of, Officers or Agents: These amounts are not secured by collateral and are, therefore, nonadmitted.

13. Travel Advances: Travel advances are nonadmitted since they are unsecured balances due from employees.

14. Surplus Notes: Insurers sometimes make subordinated surplus contributions to other insurers via an instrument variously referred to as “surplus notes”, “surplus debentures”, “contribution certificates”, ”capital notes”, etc. Generally, these instruments allow for payment of interest and repayment of principal only with the approval of the commissioner of the domiciliary jurisdiction of the insurer receiving the surplus infusion and issuing the instrument. The form and content of such instruments are also subject to regulatory approval. Where such approval conditions exist, insurers should report these instruments as admitted assets only in an amount as determined by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners. The holders of such instruments should never be allowed an admitted asset value more than that which would be allowed by considering the instruments as equity instruments and adding same to any other equity investments in the issuer held directly or indirectly by the holder of the instruments. In addition, such instruments shall be considered in the limitations on investments in affiliates. Investment income on these instruments shall not be reported as accrued until payment by the issuer has been approved by the insurer’s domiciliary commissioner.

19. Chapter 9, Nonadmitted Assets, of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance:

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

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

1. deposits in suspended depositories;
2. agents’ debit balances;
3. bills receivable which are not properly secured by collateral;
4. loans on personal security (endorsed or not) which are not properly secured by collateral;
5. cash advance to or in the hands of officers or agents;
6. travel advances;
7. depreciated cost of applications software;
8. depreciated cost of equipment and furniture;
9. prepaid loss adjustment expenses;
10. other prepaid expenses;
11. all “NSF”, post dated, payment stopped or otherwise non-bankable checks;
12. group accident and health premiums more than 90 days past due;
13. individual accident and health premiums which are more than one modal premium past due;
14. the excess of premium notes over policy reserves on individual policies;
15. collateral loans secured by assets which do not qualify as investments.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, page iv and Chapter 9
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, page v and Chapter 9
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 19—Furniture, Fixtures and Equipment

Generally Accepted Accounting Principles
None

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 92

Statement of Cash Flow

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance on the Statement of Cash Flow is contained in the Annual Statement Instructions for Life and Accident and Health Insurance Companies and the Annual Statement Instructions for Property and Casualty Insurance Companies (Annual Statement Instructions).

2. GAAP guidance on the Statement of Cash Flow is primarily contained in FASB Statement No. 95, Statement of Cash Flows (FAS 95). Under GAAP, cash receipts and payments are classified according to whether they stem from operating, investing, or financing activities. FAS 95 also requires that investing and financing activities not resulting in cash receipts or payments in the period be disclosed separately.

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

SUMMARY CONCLUSION

4. The Statement of Cash Flow shall be prepared using the direct method. Cash from operations shall be reported consistent with the Statement of Income, excluding the effect of current and prior year accruals. Only the cash portion of a transaction shall be reported in the Statement of Cash Flow. For purposes of the Statement of Cash Flow, cash shall include short term investments. Specific instructions for the classification of items are provided in the Annual Statement Instructions.

Disclosures

5. The financial statements shall disclose the following:

a. Transactions considered to be investing and financing activities that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period (in narrative or schedule form);

b. The cash and noncash aspects of the above transactions identified as investing or financing activities consistent with the classifications provided by the Annual Statement Instructions. Examples of noncash investing and financing transactions include:

i. Converting debt to equity;
ii. Acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller;
iii. Exchanging noncash assets or liabilities for other noncash assets or liabilities.
DISCUSSION

6. This issue paper changes current statutory accounting to require that only cash transactions be included in the Statement of Cash Flow. The current Annual Statement Instructions are unclear and appear to indicate that any amount shown as consideration would be included in the statement.

7. Although the broad categories of cash receipts and disbursements are similar between GAAP and statutory accounting, there are differences in the individual items included in each category. The primary objective of the statutory statement is to enhance the ability to measure and monitor solvency of a reporting entity. The statutory statement is integrated into numerous other exhibits and schedules in the Annual Statement to facilitate preparation of the Statement of Cash Flow and to provide consistent reporting of information.

8. The focus of the GAAP Statement of Cash Flows is on a broad group of users of financial information. Those users include investors and creditors whose focus is assessing financial performance of the company. GAAP also provides for the use of two distinct methods of reporting cash flows known as the direct and indirect methods. Because GAAP is not consistent with the statutory objectives discussed above, FAS 95, *FASB Statement No. 102*, Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95, and FASB Statement No. 104, Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of FASB Statement No. 95, are rejected in this issue paper.


10. Statutory guidance regarding disclosure about noncash investing and financing activities was added to provide users with complete disclosure of the investing and financing activities of a reporting entity.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

11. The Annual Statement Instructions for Property and Casualty Insurance Companies include the following guidance for the statement of cash flow. Similar language is provided in the Annual Statement Instructions for Life, Accident and Health Insurance Companies:

   The statement of cash flows is prepared using the direct method. Lines one through nine should be prepared in a manner consistent with the Statement of Income, excluding the effect of current and prior year accruals. The following provides the method of preparing the statement. All revenue, expenditures, purchase and sales items should be entered gross.

   The remaining portion of the guidance provided by the Annual Statement Instructions is a cross reference schedule which facilitates the preparation of the statement of cash flow by providing a series of calculations using various exhibits and schedules of a reporting entity’s Annual Statement.
Generally Accepted Accounting Principles


Introduction

1. This Statement establishes standards for providing a statement of cash flows in general-purpose financial statements. This Statement supersedes APB Opinion No. 19, Reporting Changes in Financial Position, and requires a business enterprise to provide a statement of cash flows in place of a statement of changes in financial position. It also requires that specified information about noncash investing and financing transactions and other events be provided separately.

2. Opinion 19 permitted but did not require enterprises to report cash flow information in the statement of changes in financial position. Since that Opinion was issued, the significance of information about an enterprise's cash flows has increasingly been recognized. In FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, paragraph 13, the Board says, “A full set of financial statements for a period should show: . . . Cash flows during the period.” Moreover, certain problems have been identified in current practice, including the ambiguity of terms such as funds, lack of comparability arising from diversity in the focus of the statement (cash, cash and short-term investments, quick assets, or working capital) and the resulting differences in definitions of funds flows from operating activities (cash or working capital), differences in the format of the statement (sources and uses format or activity format), variations in classifications of specific items in an activity format, and the reporting of net changes in amounts of assets and liabilities rather than gross inflows and outflows. The lack of clear objectives for the statement of changes in financial position has been suggested as a major cause of that diversity.

Scope

3. A business enterprise or not-for-profit organization that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided. In this Statement enterprise encompasses both business enterprises and not-for-profit organizations, and the phrase investors, creditors, and others encompasses donors. The terms income statement and net income apply to a business enterprise; the terms statement of activities and change in net assets apply to a not-for-profit organization. A statement of cash flows is not required for defined benefit pension plans and certain other employee benefit plans or for certain investment companies as provided by FASB Statement No. 102, Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale.

Purpose of a Statement of Cash Flows

4. The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period.

5. The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a) assess the enterprise’s ability to generate positive future net cash flows; (b) assess the enterprise’s ability to meet its obligations, its ability to pay dividends, and its needs for external
financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise’s financial position of both its cash and noncash investing and financing transactions during the period.

6. To achieve its purpose of providing information to help investors, creditors, and others in making those assessments, a statement of cash flows should report the cash effects during a period of an enterprise’s operations, its investing transactions, and its financing transactions. Related disclosures should report the effects of investing and financing transactions that affect an enterprise’s financial position but do not directly affect cash flows during the period. A reconciliation of net income and net cash flow from operating activities, which generally provides information about the net effects of operating transactions and other events that affect net income and operating cash flows in different periods, also should be provided.

Focus on Cash and Cash Equivalents

7. A statement of cash flows shall explain the change during the period in cash and cash equivalents. The statement shall use descriptive terms such as cash or cash and cash equivalents rather than ambiguous terms such as funds. The total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position as of those dates.

8. For purposes of this Statement, cash equivalents are short-term, highly liquid investments that are both:

   a. Readily convertible to known amounts of cash
   b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition.

9. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations). Cash purchases and sales of those investments generally are part of the enterprise’s cash management activities rather than part of its operating, investing, and financing activities, and details of those transactions need not be reported in a statement of cash flows.

10. Not all investments that qualify are required to be treated as cash equivalents. An enterprise shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition in paragraph 9 are treated as cash equivalents. For example, an enterprise having banking operations might decide that all investments that qualify except for those purchased for its trading account will be treated as cash equivalents, while an enterprise whose operations consist largely of investing in short-term, highly liquid investments might decide that all those items will be treated as investments rather than cash equivalents. An enterprise shall disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that shall be effected by restating financial statements for earlier years presented for comparative purposes.

Gross and Net Cash Flows

11. Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. However, the net amount of related receipts and payments provides sufficient information not only for cash equivalents, as noted in paragraph 9, but also for certain other classes of cash flows specified in paragraphs 12, 13, and 28.
12. For certain items, the turnover is quick, the amounts are large, and the maturities are short. For certain other items, such as demand deposits of a bank and customer accounts payable of a broker-dealer, the enterprise is substantively holding or disbursing cash on behalf of its customers. Only the net changes during the period in assets and liabilities with those characteristics need be reported because knowledge of the gross cash receipts and payments related to them may not be necessary to understand the enterprise’s operating, investing, and financing activities.

13. Items that qualify for net reporting because their turnover is quick, their amounts are large, and their maturities are short are cash receipts and payments pertaining to (a) investments (other than cash equivalents), (b) loans receivable, and (c) debt, providing that the original maturity of the asset or liability is three months or less.

Banks, savings institutions, and credit unions are not required to report gross amounts of cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans. When those enterprises constitute part of a consolidated enterprise, net amounts of cash receipts and cash payments for deposit or lending activities of those enterprises shall be reported separate from gross amounts of cash receipts and cash payments for other investing and financing activities of the consolidated enterprise, including those of a subsidiary of a bank, savings institution, or credit union that is not itself a bank, savings institution, or credit union.

Classification of Cash Receipts and Cash Payments

14. A statement of cash flows shall classify cash receipts and cash payments as resulting from investing, financing, or operating activities.

Cash Flows from Investing Activities

15. Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the enterprise (other than materials that are part of the enterprise’s inventory). Investing activities exclude acquiring and disposing of certain loans or other debt or equity instruments that are acquired specifically for resale, as discussed in Statement 102.

16. Cash inflows from investing activities are:

   a. Receipts from collections or sales of loans made by the enterprise and of other entities’ debt instruments (other than cash equivalents and certain debt instruments that are acquired specifically for resale) that were purchased by the enterprise
   b. Receipts from sales of equity instruments of other enterprises (other than certain equity instruments carried in a trading account) and from returns of investment in those instruments
   c. Receipts from sales of property, plant, and equipment and other productive assets.

17. Cash outflows for investing activities are:

   a. Disbursements for loans made by the enterprise and payments to acquire debt instruments of other entities (other than cash equivalents and certain debt instruments that are acquired specifically for resale)
   b. Payments to acquire equity instruments of other enterprises (other than certain equity instruments carried in a trading account)
c. Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets.

Cash Flows from Financing Activities

18. Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

19. Cash inflows from financing activities are:

   a. Proceeds from issuing equity instruments
   b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing.
   c. Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment.

20. Cash outflows for financing activities are:

   a. Payments of dividends or other distributions to owners, including outlays to reacquire the enterprise’s equity instruments
   b. Repayments of amounts borrowed
   c. Other principal payments to creditors who have extended long-term credit.

Cash Flows from Operating Activities

21. Operating activities include all transactions and other events that are not defined as investing or financing activities in paragraphs 15-20. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

22. Cash inflows from operating activities are:

   a. Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales. The term goods includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102.
   b. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities--interest and dividends
   c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits; proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building; and refunds from suppliers.

23. Cash outflows for operating activities are:

   a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods. The term goods includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102.
b. Cash payments to other suppliers and employees for other goods or services  
c. Cash payments to governments for taxes, duties, fines, and other fees or penalties  
d. Cash payments to lenders and other creditors for interest  
e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

24. Certain cash receipts and payments may have aspects of more than one class of cash flows. For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item. For example, the acquisition and sale of equipment to be used by the enterprise or rented to others generally are investing activities. However, equipment sometimes is acquired or produced to be used by the enterprise or rented to others for a short period and then sold. In those circumstances, the acquisition or production and subsequent sale of those assets shall be considered operating activities.

Foreign Currency Cash Flows

25. A statement of cash flows of an enterprise with foreign currency transactions or foreign operations shall report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. An appropriately weighted average exchange rate for the period may be used for translation if the result is substantially the same as if the rates at the dates of the cash flows were used. The statement shall report the effect of exchange rate changes on cash balances held in foreign currencies as a separate part of the reconciliation of the change in cash and cash equivalents during the period.

Content and Form of the Statement of Cash Flows

26. A statement of cash flows for a period shall report net cash provided or used by operating, investing, and financing activities and the net effect of those flows on cash and cash equivalents during the period in a manner that reconciles beginning and ending cash and cash equivalents.

27. In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). Enterprises that do so should, at a minimum, separately report the following classes of operating cash receipts and payments:

a. Cash collected from customers, including lessees, licensees, and the like  
b. Interest and dividends received. Interest and dividends that are donor restricted for long-term purposes as noted in paragraphs 18 and 19(c) are not part of operating cash receipts.  
c. Other operating cash receipts, if any  
d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like  
e. Interest paid  
f. Income taxes paid  
g. Other operating cash payments, if any.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category (d) above) into payments for costs of inventory and payments for selling, general, and administrative expenses.
28. Enterprises that choose not to provide information about major classes of operating cash receipts and payments by the direct method as encouraged in paragraph 27 shall determine and report the same amount for net cash flow from operating activities indirectly by adjusting net income of a business enterprise or change in net assets of a not-for-profit organization to reconcile it to net cash flow from operating activities (the indirect or reconciliation method). That requires adjusting net income of a business enterprise or change in net assets of a not-for-profit organization to remove (a) the effects of all deferrals of past operating cash receipts and payments, such as changes during the period in inventory, deferred income, and the like, and all accruals of expected future operating cash receipts and payments, such as changes during the period in receivables and payables, and (b) the effects of all items whose cash effects are investing or financing cash flows, such as depreciation, amortization of goodwill, and gains or losses on sales of property, plant, and equipment and discontinued operations (which relate to investing activities), and gains or losses on extinguishment of debt (which is a financing activity).

29. The reconciliation of net income of a business enterprise or change in net assets of a not-for-profit organization to net cash flow from operating activities described in paragraph 28 shall be provided regardless of whether the direct or indirect method of reporting net cash flow from operating activities is used. That reconciliation shall separately report all major classes of reconciling items. For example, major classes of deferrals of past operating cash receipts and payments and accruals of expected future operating cash receipts and payments, including at a minimum changes during the period in receivables pertaining to operating activities, in inventory, and in payables pertaining to operating activities, shall be separately reported. Enterprises are encouraged to provide further breakdowns of those categories that they consider meaningful. For example, changes in receivables from customers for an enterprise’s sale of goods or services might be reported separately from changes in other operating receivables. In addition, if the indirect method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period shall be provided in related disclosures.

30. If the direct method of reporting net cash flow from operating activities is used, the reconciliation of net income of a business enterprise or change in net assets of a not-for-profit organization to net cash flow from operating activities shall be provided in a separate schedule. If the indirect method is used, the reconciliation may be either reported within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities. If the reconciliation is presented in the statement of cash flows, all adjustments to net income of a business enterprise or change in net assets of a not-for-profit organization to determine net cash flow from operating activities shall be clearly identified as reconciling items.

31. Except for items described in paragraphs 12 and 13, both investing cash inflows and outflows and financing cash inflows and outflows shall be reported separately in a statement of cash flows—for example, outlays for acquisitions of property, plant, and equipment shall be reported separately from proceeds from sales of property, plant, and equipment; proceeds of borrowings shall be reported separately from repayments of debt; and proceeds from issuing stock shall be reported separately from outlays to reacquire the enterprise’s stock.

Information about Noncash Investing and Financing Activities

32. Information about all investing and financing activities of an enterprise during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be reported in related disclosures. Those disclosures may be either narrative or summarized in a schedule, and they shall clearly relate the cash and noncash aspects of transactions involving similar items. Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; obtaining an asset by entering into a capital lease; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities. Some transactions are part
cash and part noncash; only the cash portion shall be reported in the statement of cash flows.

Cash Flow per Share

33. Financial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise’s performance, as reporting per share amounts might imply.

13. FASB Emerging Issues Task Force Issue No. 95-13, Classification of Debt Issue Costs in the Statement of Cash Flows contains the following guidance:

ISSUE
Debt issue costs generally are incurred in connection with the issuance of debt securities or other short- or long-term borrowings. Opinion 21 requires that debt issue costs be reported in the balance sheet as deferred charges. Generally, debt issue costs are capitalized as an asset and amortized over the term of the debt.

Statement 95 requires that cash receipts and payments in a statement of cash flows be classified as operating, investing, or financing activities. However, some believe that Statement 95 does not provide specific guidance on the classification of debt issue costs in the statement of cash flows. Because debt issue costs have aspects of more than one class of cash flows, diversity in practice has arisen. Some companies have reported the cash outflow for debt issue costs as a financing activity, while others have reported the outflow for those costs as an operating activity.

The issue is how cash payments for debt issue costs should be classified in the statement of cash flows.

EITF DISCUSSION
The Task Force reached a consensus that cash payments for debt issue costs should be classified in the statement of cash flows as a financing activity.

RELEVANT LITERATURE

Statutory Accounting
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies

Generally Accepted Accounting Principles
- FASB Statement No. 95, Statement of Cash Flows
- FASB Statement No. 102, Statement of Cash Flows--Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 94

Allocation of Expenses

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Expenses involved in acquiring and underwriting policies and servicing policyholders and third-party claimants are important elements of a reporting entity’s operations. Uniformity in the classification, allocation and reporting of expenses and expense statistics by reporting entities within the same industry is critical in a regulatory environment and is consistent with both the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) and the FASB Statements of Financial Accounting Concepts (GAAP Statement of Concepts). Such uniformity is necessary for the effective review of operations of a specific entity, comparisons across the industry and control/regulation of the industry.


3. This issue paper establishes rules on presentation and allocation of certain expenses of reporting entities into general categories and the apportionment of shared expenses between members of a group of companies. The scope of this issue paper is limited to the general categories. Disclosure in notes or exhibits to the financial statements is required for principal components of those categories.

SUMMARY CONCLUSION

4. This paper establishes uniform expense allocation rules to classify expenses within prescribed principal groupings. It is necessary to allocate those expenses which may contain characteristics of more than one classification, which this issue paper will refer to as allocable expenses.

5. Allocable expenses for property and casualty insurance companies shall be classified into one of three categories on the Underwriting and Investment Exhibit as follows:

- Loss adjustment expenses - Expenses incurred in the adjusting, recording and paying of claims (including expenses associated with commutations).
- Investment expenses - Expenses incurred in the investing of funds and pursuit of investment income. Such expenses include those specifically identifiable and allocated costs related to activities such as initiating and handling orders, researching and recommending investments (i.e., investment strategy), appraising, valuing, disbursing funds and collecting income, securities safekeeping, real estate taxes, records maintenance, data processing, support personnel, postage and supplies, office overhead, management and executive duties and all other functions reasonably associated with the investment of funds.
• Other underwriting expenses - Allocable expenses other than loss expenses and investment related expenses.

6. Similarly for life and accident and health insurers allocable expenses shall be categorized as general insurance expenses; insurance taxes, licenses and fees; or investment expenses which are netted against investment income on the Summary of Operations.

7. Allocation to the above categories should be based on a method that yields the most accurate results. Specific identification of an expense with an activity that is represented by one of the categories above will generally be the most accurate method. Where specific identification is not feasible allocation of expenses should be based upon pertinent factors or ratios such as studies of employee activities, salary ratios or similar analyses.

8. Allocation may be entirely to one expense category based upon the type of expense incurred, for example, premium taxes would be 100% allocated to Other Underwriting Expenses for property and casualty companies. Other expenses may be allocated across several categories, such as salaries, which may be allocated to both general insurance expenses and net investment income of a life and accident and health company.

9. Many entities operate within a group where personnel and facilities are shared. Shared expenses, including expenses under the terms of a management contract, shall be apportioned to the entities incurring the expense as if the expense had been paid solely by the incurring entity. The apportionment shall be completed based upon specific identification to the entity incurring the expense. Where specific identification is not feasible apportionment shall be based upon pertinent factors or ratios. Any basis adopted to apportion expenses shall be that which yields the most accurate results and may result from special studies of employee activities, salary ratios, premium ratios or similar analyses. Expenses that relate solely to the operations of a reporting entity, such as personnel costs associated with the adjusting and paying of claims, must be borne solely by the reporting entity and are not to be apportioned to other entities within a group. Pertinent factors in making this determination shall include which entity has the ultimate obligation to pay the expense. Apportioned expenses are subject to presentation and allocation as provided in paragraphs 5 through 8.

10. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related exhibits to the financial statements.

DISCUSSION

11. The summary conclusions outlined above were formulated based upon, and are consistent with, current statutory accounting practices and procedures as set out in the P&C and Life/A&H Accounting Practices and Procedures Manuals, the Annual Statement Instructions and additional guidance contained in the Financial Condition Examiners Handbook. The conclusions are also consistent with the Statutory Statements of Concepts which states the following:

SAP utilizes the framework established by GAAP.

Consistency
The regulators’ need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles.

The conclusions are also consistent with the GAAP Statements of Concepts which are excerpted in paragraphs 16 and 17.
12. The exhibits to the annual statement display the effects of allocation of allocable expenses to the various categories as well as provide an appropriate level of detail as to the nature of the classifications of expenses being allocated. The disclosure required by Paragraph 10 provides disclosure as to the nature of the significant allocable expenses in those circumstances where the accompanying exhibits are not part of the company’s financial statements (e.g. annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

Drafting Notes/Comments
- Detailed classification tables, which are included in current statutory guidance for property and casualty companies, are not included in this issue paper. Such guidance is not considered necessary for the establishment of accounting standards/policies.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
13. The P&C Accounting Practices and Procedures Manual, Chapter 19, Expenses, provides the following guidance:

In the insurance industry, there are expenses involved in acquiring and underwriting policies and servicing the policyholders and third party claimants. These expenses will be discussed in this chapter. (Commissions are discussed in Chapter 18.)

Regulation Number 30, called the "Uniform Classification of Expenses of Fire and Marine and Casualty and Surety Insurer," was effective January 1, 1949, for licensed New York companies. The NAIC prescribed similar uniform accounting instructions for expense reporting effective January 1, 1949. These acts brought uniformity to the industry.

This uniformity is helpful since expenses are important elements of the company’s operations and accurate statistics are needed for comparisons and control. The instructions for uniform classification of expenses are a part of the NAIC Examiners Handbook—Volume I.

Expense Group Classifications

Expenses for fire and casualty insurance companies are allocated to expense groups as follows:

A. Loss Adjustment Expenses

Loss adjustment expenses constitute expenses incurred in connection with the adjusting, recording, and paying of claims. (See Chapter 17-Loss and Loss Adjustment Expenses Incurred.)

B. Other Underwriting Expenses

Other underwriting expenses are classified into three categories as follows:
1. **Acquisition, Field Supervision, and Collection Expenses**

   Acquisition costs consist of all expenses incurred in relation to the production of new and renewal insurance business. Also included are specifically identifiable and allocated expenses relating to the following activities: commissions, bonuses, allowances, and other compensation paid to agents and brokers; operating costs for agencies or branch offices; training agents and brokers; underwriting new risks; issuing new policies; receiving and paying of premiums and commissions; maintaining general and detailed records; data processing; advertising and publicity; clerical, secretarial, office maintenance, supervisory, and executive duties; postage and supplies; and all other functions reasonably associated with the production of new and renewal insurance business, such as premium collection.

2. **General Expenses**

   This category includes all expenses not assignable to other expense groups.

3. **Taxes, Licenses, and Fees**

   These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

   All other taxes might include: (1) qualifying bond premiums; (2) statement publication fees; (3) advertising required by law; (4) personal property taxes; (5) state income taxes; (6) capital stock taxes; (7) business or corporation licenses or fees; (8) marine profits taxes; (9) documentary stamps on reinsurance; (10) guaranty association assessments; and (11) any other taxes.

   Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

C. **Investment Expenses**

   These comprise expenses incurred in the investing of funds and the pursuit of investment income, including specifically identifiable and allocated expenses related to such activities as: initiating or handling orders and recommendations for investments; research; pricing; appraising and valuing; disbursing funds and collecting income; safekeeping of securities and valuable papers; maintaining general and detailed records; data processing; general clerical, secretarial, office maintenance, supervisory, and executive duties; supplies, postage, and the like; and all other functions reasonably attributable to the investment of funds.

**Allocation of Expenses to Expense Groups**

Some general guidelines for allocating to expense groups are shown in the following table. The expenses shown are those in the annual statement.
### TABLE 19

**General Guidelines for Classifying Expenses**

<table>
<thead>
<tr>
<th>Expenses to be Allocated to Expense Groups</th>
<th>Principal Basis for Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claim adjustment services</td>
<td>Direct charge to loss adjustment expense</td>
</tr>
<tr>
<td>Commission and brokerage</td>
<td>Direct charge to other underwriting acquisition</td>
</tr>
<tr>
<td>Advertising</td>
<td>Direct charge to other underwriting acquisition</td>
</tr>
<tr>
<td>Boards, bureaus, associations</td>
<td>Direct charge to other underwriting - general</td>
</tr>
<tr>
<td>Surveys and underwriting reports</td>
<td>Direct charge to other underwriting - general</td>
</tr>
<tr>
<td>Audit of insureds’ records</td>
<td>Direct charge to other underwriting - general</td>
</tr>
<tr>
<td>Salaries</td>
<td>Studies of employee activities</td>
</tr>
<tr>
<td>Employee relations and welfare</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Insurance</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Directors’ fees</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Travel and travel items</td>
<td>Special studies</td>
</tr>
<tr>
<td>Rent and rent items</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Equipment</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Printing and stationery</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Postage, telephone and telegraph, exchange and express</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Legal and auditing</td>
<td>Special studies</td>
</tr>
<tr>
<td>Taxes, licenses, and fees (Except payroll taxes)</td>
<td>Special studies</td>
</tr>
<tr>
<td>Real estate expenses</td>
<td>Investment expenses</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>Investment expenses</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Special studies</td>
</tr>
</tbody>
</table>

Any other basis of allocation which yields a more accurate result may be used for those expenses being allocated on the basis of salaries. Any basis of allocation which is found to be inappropriate should be discounted.
Apportionment of Joint Expenses

Many insurance companies operate on a group basis, sharing personnel and facilities in conducting business. When this occurs, the expenses involved must be properly apportioned to the company incurring the expenses, and included in the same expense classifications as if originally paid by that company.

Some examples of specifically identifiable expenses that may be incurred solely on behalf of one company, and charged directly to the applicable company are:

1. Advertising;
2. Claims adjustment services;
3. Commissions and brokerages;
4. Taxes and real estate expenses;
5. Employees’ salaries;
6. Any other expenses that can be attributed directly in whole or in part to a specific company.

The following table contains some general guidelines for apportioning joint expenses among companies.

**TABLE 19-B**
General Guidelines for Apportioning Joint Expenses

<table>
<thead>
<tr>
<th>Expense Item</th>
<th>Basis for Apportionment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>Percentage of premiums</td>
</tr>
<tr>
<td>Boards, bureaus, associations</td>
<td>Special studies</td>
</tr>
<tr>
<td>Surveys and underwriting reports</td>
<td>Special studies</td>
</tr>
<tr>
<td>Audit of insureds’ records</td>
<td>Special studies</td>
</tr>
<tr>
<td>Salaries</td>
<td>Studies of employee activities</td>
</tr>
<tr>
<td>Employee relations and welfare</td>
<td>Salaries</td>
</tr>
<tr>
<td>Insurance</td>
<td>Salaries</td>
</tr>
<tr>
<td>Travel and travel items</td>
<td>Special studies</td>
</tr>
<tr>
<td>Rent and rent items</td>
<td>Salaries</td>
</tr>
<tr>
<td>Equipment</td>
<td>Salaries</td>
</tr>
<tr>
<td>Printing and Stationery</td>
<td>Salaries</td>
</tr>
<tr>
<td>Postage, telephone and telegraph, exchange and express</td>
<td>Salaries</td>
</tr>
</tbody>
</table>
Legal and auditing    Special studies
Payroll taxes        Salaries
Miscellaneous        Special studies

Any other basis of allocation should be used if it yields more precise results than expenses allocated on the salaries or premium basis. If clearly inappropriate, allocation based on salaries or premium should not be employed.

A company that pays joint expenses, which are ultimately apportioned and charged to other companies in the group, should credit the apportioned expenses to the same expense items charged when the payment was made. Apportionment expenses generally should not be reported as income nor be accumulated in a separate account used to reduce total expenses for the company.

14. The Life/A&H Accounting Practices and Procedures Manual, Chapter 22, General Expenses and Taxes, Licenses and Fees, provides the following guidance:

General expenses include virtually all of the expenses of a life insurance company other than benefits to policyholders, commissions, and taxes, licenses and fees.

The statutory financial statement provides for two broad categories of general expenses: (1) insurance, which is further subdivided into life insurance, accident and health insurance, and all other lines of business and (2) investment. In addition, general expenses are allocated to more detailed lines of business in the Analysis of Operations by Lines of Business. In the Summary of Operations, the investment expense portion of general expenses is classified as an offset to investment income while general insurance expenses are reported separately in the expense section of the summary.

15. The Annual Statement Instructions for Property and Casualty Companies - Underwriting and Investment Exhibit - Part 4 - Expenses provides the following guidance:

A company that pays any affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification items (salaries, rent, postage, etc.) as if these costs had been borne directly by the company. Management, administration, or similar fees should not be reported as a one-line expense. The company may estimate these expense allocations based on a formula or other reasonable basis.

A company that pays any non-affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification item as follows:

a) Payments for claims handling or adjustment services shall be allocated to “Loss Adjustment Expenses” (Column 1) in the Underwriting and Investment Exhibit–Part 4. If the total of such expenses incurred equals or exceeds 10% of the total incurred “Loss Adjustment Expenses” (Column 1, Line 22), the company shall allocate these costs to the appropriate expense classification items as if these costs had been borne directly by the company. If such expenses are less than 10% of the total, they may be reported on Line 1 of Column 1.

b) Payments for services other than claims handling or adjustment services shall be allocated to the appropriate expense classification items as if these costs had been borne directly by the company, if the total of such fees paid equals or exceeds 10% of the total incurred “Other Underwriting Expenses” (Column 2, Line 22). If the total is less then 10%, the payments may be reported on Line 2 if the fees are calculated as a percentage of premium, or on Line 3 if the fees are not calculated as a percentage of premium.
The total management and service fees paid to affiliates and non-affiliates shall be reported in the footnote to the Underwriting and Investment Exhibit-Part 4 of the annual statement, and the method(s) used for allocation shall be disclosed in the Notes to the Financial Statements. The company shall use the same allocation method(s) on a consistent basis.

The Annual Statement Instructions for Life and Accident and Health Companies contains similar guidance.

**Generally Accepted Accounting Principles**

16. *FASB Statement of Financial Accounting Concepts No. 2, Summary of Principal Conclusions*, provides the following guidance:

Comparability and Consistency

Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user’s ability to relate it to some benchmark.

17. *FASB Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises*, provides the following guidance:

paragraph 20

Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar.

**OTHER SOURCES OF INFORMATION**

18. The Financial Condition Examiners Handbook - Volume 1, Chapter 6 provides the following guidance:

22. **GENERAL INSTRUCTIONS IN CONNECTION WITH OPERATING EXPENSE CLASSIFICATIONS**

A. Joint Expenses

Whenever personnel or facilities are used in common by two or more companies, or whenever the personnel or facilities of one company are used in the activities of two or more companies, the expenses involved shall be apportioned in accordance with the regulations relating to Joint Expenses, and such apportioned expenses shall be allocated by each company to the same operating expense classifications as if the expenses had been borne wholly. Any difference between the actual amount paid, and the amount of such apportioned expenses shall be included in the operating expense classification "Miscellaneous."
PART II
RULES RELATING TO THE ALLOCATION OF JOINT EXPENSES TO COMPANIES

1. JOINT EXPENSES

A. Joint Expenses, as described in Part 1, Sec. 22 (A), shall be allocated to companies as follows:

<table>
<thead>
<tr>
<th>Expenses To Be Allocated To Companies (as amended)</th>
<th>Bases of Allocation to Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>Premiums</td>
</tr>
<tr>
<td>Boards, Bureaus, and Associations</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Surveys and Underwriting Reports</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Audit of Assureds’ Records</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Salaries</td>
<td>See Special Instructions Relating to the Allocation of Salaries and Other Expenses (Part V)</td>
</tr>
<tr>
<td>Employee Relations and Welfare</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Insurance</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Travel and Travel Items</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Rent and Rent Items</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Equipment</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Printing and Stationery</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Postage, Telephone and Telegraph, Exchange and Express</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Legal and Auditing</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Special Studies</td>
</tr>
</tbody>
</table>

B. Definitions

The term Premiums used as a basis of allocation means that the allocation of expenses shall follow the percentages of applicable premiums.

The term Special Studies used as a basis of allocation means that expenses shall be analyzed and bases of allocation applied as dictated by that analysis.

The term Overhead on Salaries used as a basis of allocation means that the allocation of expenses shall follow the percentages of the applicable salaries allocation.

C. Other Bases Permitted or Prescribed

For those operating expense classifications permitting the basis, Overhead on Salaries or Premiums, any other basis of allocation may be adopted which yields more accurate results. The bases Overhead on Salaries and Premiums shall not be used if clearly in appropriate.

PART III
RULES RELATING TO THE COMPOSITION OF, AND ALLOCATION TO, EXPENSE GROUPS

(as amended 1953 Proc. II 643-644)
1. LIST OF EXPENSE GROUPS

Expense reported in the operating expense classifications shall be allocated to the following expense groups:

Investment Expenses
Loss Adjustment Expenses
Acquisition, Field Supervision and Collection Expenses
Taxes
General Expenses

2. COMPOSITION OF THE EXPENSE GROUPS (as amended)

The composition of each group shall be as follows:

A. Investment Expenses

Investment Expenses shall comprise all expenses incurred wholly or partially in connection with the investing of funds and the obtaining of investment income, including related expenses incurred in the following activities: initiating or handling orders and recommendations; doing research; pricing; appraising and valuing; paying and receiving; entering and keeping general and detail records, safe keeping; collecting, recording, calculating and accruing investment income; general clerical, secretarial, office maintenance, supervisory and executive duties; handling personnel, supplies, mail, etc.; and all other activities reasonably attributable to the investing of funds and the obtaining of investment income.

B. Loss Adjustment Expenses

Loss Adjustment Expenses shall comprise all expenses incurred wholly or partially in connection with the adjustment and recording of policy claims, including the totals of the operating expense classification, Claim Adjustment Services; the types of expenses included in Claim Adjustment Services, when the activities resulting in such types of expenses are performed by employees; and including related expenses incurred in the following activities: estimating amounts of claims; paying and receiving; entering and keeping general and detail records; general clerical, secretarial, office maintenance, supervisory and executive duties; handling personnel, supplies, mail, etc.; and all other activities reasonably attributable to the adjustment and recording of policy claims in connection with claims reported, paid and outstanding, and reinsurance thereon.

C. Acquisition, Field Supervision, and Collection Expenses

(1) Acquisition, Field Supervision and Collection Expenses shall comprise all expenses incurred wholly or partially in the following activities:

a. Soliciting and procuring business and developing the sales field;

b. Writing policy contracts, and checking and directly supervising the work of policy writers;

c. Receiving and paying of premiums and commissions; entering into or setting up records of premiums and commissions receivable and payable for collection purposes; balancing and maintaining such records; corresponding with and visiting insureds and producers for the purpose of collecting premiums or adjusting differences; checking current accounts from producers; auditing of records of delinquent agents; and services of collection agencies; (Do not include activities in connection with accounts receivable from and payable to branch or other officers within the company.)

d. Compiling and distributing expiration lists, notices of premiums due, lists of premiums or premium balances receivable and payable, contingent and other commission statements, production statements for acquisition and field supervision purposes, and similar data;
e. Maintaining good will of insureds and producers; activities of field men; contact work related to acquisition, field supervision and collection; making contracts and agreements with producers; and activities in connection with agency appointments and replacements; (Do not include: inspections of risks when carried on by personnel employed by the insurance company, engaged full time in physical inspection of risks and activities directly related thereto; audits for the purpose of premium determination; and activities in connection with the adjustment of policy claims.)

f. Rendering service to agents and other producers, such as providing office space, personnel, telephone, etc. and obtaining agents’ licenses; (Do not include fees paid for agents’ licenses.)

g. Advertising and publicity of every nature related to acquisition, field supervision and collection; (In addition to applicable salaries, etc., include the entire amount shown in the operating expense classification, Advertising.)

h. Miscellaneous activities of agents, brokers and producers other than employees, when performed by them: inspections; quoting premiums; signing policies; examining and mailing policies, applications and daily reports; compiling figures for current account; correspondence and sundry bookkeeping and clerical work;

i. Other activities reasonably attributable to those operations listed in “a” to “h,” such as: keeping general and detail records; paying and receiving, general clerical, secretarial, office maintenance, supervisory and executive work; and handling personnel, supplies, mail, etc.

(2) Commission and Allowances: When the whole or a part of any amount in the operating expense classifications Commission and Brokerage—Direct, and Allowances to Managers and Agents is paid specifically for services other than those set forth under “a” to “i,” and when such services are not duplicated or otherwise compensated by the company, the amount thereof shall be allocated to expense groups other than Acquisition, Field Supervision and Collection, and such allocations shall be justified by detailed statements and data calculated and prepared in accordance with the methods prescribed in these Rules showing amounts of expenditures, property allocated to expense groups and lines of business.

When Allowances to Managers and Agents represent a division of expenses shared with other companies, the aforementioned statements and data shall show the division of such shared expenses calculated and prepared in accordance with the methods prescribed in these Rules.

The calculation and preparation of the aforementioned statements and data shall be subject to verification and audit by insurance department personnel.

The instructions under the heading Commission and Allowances to not apply to Commission and Brokerage—Reinsurance Assumed, or Commission and Brokerage—Reinsurance Ceded.

D. Taxes

Taxes shall comprise the totals of the operating expense classification Taxes, Licenses and Fees.

E. General Expenses

General Expenses shall comprise all expenses not assignable by these rules to other expense groups.
### 3. ALLOCATION TO EXPENSE GROUPS (as amended)

#### A. Expenses shall be allocated to expense groups as follows:

<table>
<thead>
<tr>
<th>Expenses To Be Allocated</th>
<th>Allocation to Expense Groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claim Adjustment Services:</td>
<td></td>
</tr>
<tr>
<td>Direct</td>
<td>Loss Adjustment Expenses</td>
</tr>
<tr>
<td>Reinsurance Assumed</td>
<td>Loss Adjustment Expenses</td>
</tr>
<tr>
<td>Reinsurance Ceded</td>
<td>Loss Adjustment Expenses</td>
</tr>
<tr>
<td>Commission and Brokerage:</td>
<td></td>
</tr>
<tr>
<td>Direct</td>
<td>See Commission and Allowances (Part III, Sec. 2 (C)(2))</td>
</tr>
<tr>
<td>Reinsurance Assumed</td>
<td>Acquisition, Field Supervision and Collection Expenses</td>
</tr>
<tr>
<td>Reinsurance Ceded</td>
<td>Acquisition, Field Supervision and Collection Expenses</td>
</tr>
<tr>
<td>Contingent—Net</td>
<td>Acquisition, Field Supervision and Collection Expenses</td>
</tr>
<tr>
<td>Policy and Membership Fees</td>
<td>See Commission and Allowances (Part III, Sec. 2 (C)(2))</td>
</tr>
<tr>
<td>Allowances to Managers and Agents</td>
<td>Acquisition, Field Supervision and Collection Expenses</td>
</tr>
<tr>
<td>Advertising</td>
<td></td>
</tr>
<tr>
<td>Boards, Bureaus and Associations</td>
<td>General Expenses</td>
</tr>
<tr>
<td>Surveys and Underwriting</td>
<td>General Expenses</td>
</tr>
<tr>
<td>Reports</td>
<td>General Expenses</td>
</tr>
<tr>
<td>Audit of Assureds’ Records</td>
<td>See Special Instructions Relating to the Allocation of Salaries and Other Expenses (Part V)</td>
</tr>
<tr>
<td>Salaries</td>
<td>Overhead on Salaries</td>
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<tr>
<td>Employee Relations and Welfare</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Insurance</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Directors’ Fees</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Travel and Travel Items</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Rent and Rent Items</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Equipment</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Printing and Stationery</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Postage, Telephone and Telegraph, Exchange and Express</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Legal and Auditing</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Taxes, Licenses and Fees</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Real Estate Expenses</td>
<td>Taxes</td>
</tr>
<tr>
<td>Real Estate Taxes</td>
<td>Investment Expenses</td>
</tr>
<tr>
<td>Income from Special Services</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Special Studies</td>
</tr>
</tbody>
</table>

#### B. Definitions

For definitions of the term Overhead on Salaries and Special Studies, see Part II, Sec. 1 (B).

#### C. Other Bases Permitted or Prescribed

For those operating expense classifications permitting the basis Overhead on Salaries, any other basis of allocation may be adopted which yields more accurate results. The basis Overhead on Salaries shall not be used if clearly inappropriate.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22
- Annual Statement Instructions for Property and Casualty Companies and for Life and Accident and Health Companies

Generally Accepted Accounting Principles
- FASB Statement of Financial Accounting Concepts No. 2, Summary of Principal Conclusions

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

Other Sources of Information
- Financial Condition Examiners Handbook - Volume 1, Chapter 6
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Statutory Issue Paper No. 95

Holding Company Obligations

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting currently requires disclosure of holding company obligations which are guaranteed. It does not specifically address a reporting entity subsidiaries’ accounting treatment of obligations of a holding company parent when the subsidiary does not guarantee the obligation, however, it is accepted statutory practice that these obligations are not recorded or disclosed.

2. The Financial Accounting Standards Board (FASB) has been unable to reach a consensus that any particular method of presentation is preferable related to this issue. The SEC staff believes that when debt is incurred in connection with or otherwise related to the acquisition of a subsidiary in a purchase transaction and a subsidiary subsequently files a registration statement in connection with a public offering of its stock or debt, the parent company’s debt, related interest expense, and allocable debt issue costs should be reflected in the subsidiary’s financial statements included in the public offering if (1) the subsidiary is to assume the debt of the parent, either presently or in a planned transaction in the future, (2) the proceeds of a debt or equity offering of the subsidiary will be used to retire all or a part of the parent company’s debt, or (3) the subsidiary guarantees or pledges its assets as collateral for the parent company’s debt.

3. The purpose of this issue paper is to establish statutory accounting principles for recording and disclosure requirements of holding company obligations and any related guarantees in the financial statements of a subsidiary that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. In situations where the reporting entity does not guarantee the obligation of the holding company, there is no legal obligation on the part of the reporting entity. Therefore, the reporting entity shall not record the obligation of its parent holding company unless the obligation relates to services or benefits incurred by a non-insurance parent company or holding company on its behalf. In these situations, the reporting entity shall recognize an expense for its share of the services or benefits incurred on its behalf during the period by the parent company or holding company based on an allocation from the parent or holding company. A liability shall be established for any such amounts due, but not yet paid. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. Issue Paper No. 8—Accounting for Pensions (Issue Paper No. 8), Issue Paper No. 11—Compensated Absences (Issue Paper No. 11), Issue Paper No. 13—Employers’ Accounting for Postemployment Benefits (Issue Paper No. 13), and Issue Paper No. 14—Employers’ Accounting for Postretirement Benefits Other Than Pensions (Issue Paper No. 14) address specific examples where the obligation relates to benefits provided to the subsidiary by a non-insurance parent company or holding company.

5. If the reporting entity guarantees an obligation of the holding company, the guidance in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) shall be followed for determining the recording and disclosure of the guarantee. Issue Paper Nos. 8, 11,
13 and 14 provide specific accounting and disclosure guidelines for employee benefit plans when the reporting entity is directly liable for obligations under the plan.

**DISCUSSION**

6. Statutory accounting requires that a reporting entity record only its direct assets and direct obligations and not those of related parties. If the reporting entity has no legal obligation related to the holding company’s obligations, the entity shall not record those obligations unless there is a guarantee of such debt that would require recording under the guidance in Issue Paper No. 5 or unless the obligation falls under the requirements discussed in paragraph 4. This is supported by the recognition concept included in the Statement of Concepts.

7. This issue paper rejects the requirements of *SEC Staff Accounting Bulletin No. 73, Push-Down Basis of Accounting Required in Certain Limited Circumstances* (SAB 73). The subsidiary has no direct legal obligation and, therefore, SAB 73 is inconsistent with statutory accounting principles as described in the Statement of Concepts. Other than the instances described in paragraph 4, the only way funding can be provided by the reporting entity to the holding company is through the payment of dividends and these payments are restricted to the amounts approved by the state insurance departments for the purpose of providing protection of surplus. As a result, the holding company can not legally require the reporting entity to fund debt payments in excess of the allowable dividends.

**Drafting Notes/Comments**

None

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

8. As discussed above, there is no current statutory guidance specifically related to this issue. The following disclosure requirements are outlined in the NAIC Annual Statement Instructions for Property and Casualty Companies - Notes to Financial Statements:

5. **Information Concerning Parent, Subsidiaries and Affiliates**
   
e. Describe guarantees or undertakings for the benefit of an affiliate which result in a material contingent exposure of the company’s or any affiliated insurer’s assets to liability, if not disclosed. Report the total amount of guarantees for affiliates.

9. **Contingent Liabilities**
   
a. Report briefly the nature of any material contingent liabilities including but not limited to: notes receivable discounted, reverse repurchase agreements, accounts and agents’ balances assigned, accommodation paper, additional taxes, guarantees of liabilities of other companies (including companies that act as dealers in Over the Counter derivative instruments or as a Futures Commission Merchant establishing of compensating balances, long-term contracts, loan take-out agreements and indemnification agreements, deferred expense contracts, structured settlements and arrangements between parents, subsidiaries or affiliates. Include in the disclosure: The date incurred or discovered; the nature of the contingent liability, contract, agreement or commitment; the amount or amounts, if known; the status as of the annual statement date; and all other information necessary for a full disclosure. Report the total amount of contingent liabilities.

The Annual Statement Instructions for Life and Accident and Health Companies contain similar requirements.
OTHER SOURCES OF INFORMATION

9. SAB 73 provides the following guidance:

Facts:
Company A (or Company A and related persons) acquired substantially all of the common stock of Company B in one or a series of purchase transactions.

Question 1:
Must Company B’s financial statements presented in either its own or Company A’s subsequent filings with the Commission reflect the new basis of accounting arising from Company A’s acquisition of Company B when Company B’s separate corporate entity is retained?

Interpretative Response:
Yes. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned (as defined in Rule 1-02 (z) of Regulation S-X) establish a new basis of accounting for the purchased assets and liabilities.

When the form of ownership is within the control of the parent the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent’s operations. Therefore, Company A’s cost of acquiring Company B should be “pushed down”, i.e., used to establish a new accounting basis in Company B’s separate financial statements.

Question 2:
What is the staff’s position if Company A acquired less than substantially all of the common stock of Company B or Company B had publicly held debt or preferred stock at the time Company B became wholly owned?

Interpretative Response:
The staff recognizes that the existence of outstanding public debt, preferred stock or a significant minority interest in a subsidiary might impact the parent’s ability to control the form of ownership. Although encouraging its use, the staff generally does not insist on the application of push down accounting in these circumstances. [Added by SAB No. 54, 11/3/83]

Question 3:
Company A borrows funds to acquire substantially all of the common stock of Company B. Company B subsequently files a registration statement in connection with a public offering of its stock or debt. Should Company B’s new basis (“push down”) financial statements include Company’s A debt related to its purchase of Company B?

Interpretative Response:
The staff believes that Company A’s debt, related interest expense and allocable debt issue costs should be reflected in Company B’s financial statements included in the public offering (or an initial registration under the Exchange Act) if: (1) Company B is to assume the debt of Company A, either presently or in a planned transaction in the future; (2) the proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A’s debt; or (3) Company B guarantees or pledges its assets as collateral for Company A’s debt.

Other relationships may exist between Company A and Company B, such as the pledge of Company B’s stock as collateral for Company A’s debt. While in this latter situation, it may be clear that Company B’s cash flows will service all or part of Company A’s debt, the staff does not insist that the debt be reflected in Company B’s financial statements providing there is full and prominent disclosure of the relationship between the Companies A and B and the actual or potential cash flow commitment. In this regard, the staff believes that Statements of Financial Accounting Standards Nos. 5 and 57 requires sufficient disclosure to allow users of Company B’s financial statements to fully understand the impact of the relationship on Company B’s present and future cash flows. Rule 4-08(e) of Regulation S-X (17 CFR 210.4-08(e)) also requires...
disclosure of restrictions which limit the payment of dividends. Therefore, the staff believes that the equity section of Company B’s balance sheet and any pro forma financial information and capitalization tables should clearly disclose that this arrangement exists.\(^{(4)}\)

Regardless of whether the debt is reflected in Company B’s financial statements, the notes to Company B’s financial statements should generally disclose, at a minimum: (1) the relationship between Company A and Company B; (2) a description of any arrangements that result in Company B’s guarantee, pledge of assets or stock, etc. that provides security for Company A’s debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B’s cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B’s ability to pay dividends or other amounts to holders of its securities.

Additionally, the staff believes Company B’s Management’s Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of the servicing of Company A’s debt on its own liquidity pursuant to Item 303(a)(1) of Regulations S-K (17 CFR 229.303(a)(1)). (Added by SAB No. 73, 12/30/87.)

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 8—Accounting for Pensions
- Issue Paper No. 11—Compensated Absences
- Issue Paper No. 13—Employers’ Accounting for Postemployment Benefits
- Issue Paper No. 14—Employers’ Accounting for Postretirement Benefits Other Than Pensions

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

**Other Sources of Information**
- SEC Staff Accounting Bulletin No. 73
Statutory Issue Paper No. 96

Other Liabilities

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for the other liabilities is provided in Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies and Chapter 13, Other Liabilities, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies.

2. The purpose of this issue paper is to establish statutory accounting principles for other liabilities, including self-insurance reserves, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For purposes of identifying other liabilities, the discussion, definition and accounting treatment outlined in Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) must be considered. This paper is not an all inclusive list of other liabilities. Certain other liabilities are covered in other issue papers. All other liabilities, whether or not specifically identified in this issue paper shall be recorded and disclosed in accordance with Issue Paper No. 5, which states that “a liability shall be recorded on a reporting entity’s financial statements when incurred”.

4. Specific accounting treatment and where appropriate, a definition of certain other liabilities, is discussed below.

Self-Insurance

5. Self-insurance occurs when an entity retains insurance risks associated with the entity’s day-to-day operations that are commonly transferred to an insurer through an insurance contract. Self-insurance can also be described as a decision not to insure or non-insurance. To the extent that an event occurs, obligating the entity in accordance with the definition of a liability or impairment of an asset in Issue Paper No. 5, for which insurance coverage has not been obtained, the entity shall record either the appropriate write-down of the assets, if applicable, or reserves shall be established using the same estimation methodology an insurance company uses when an insurance contract is issued for the type of insurance risk which is self-insured. Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses describes the specific reserving guidance which should be followed.

6. The related costs should be treated similarly to comparable expenses and allocated appropriately (see Issue Paper No. 94—Allocation of Expenses). As a result of this treatment, the costs are accounted for based on the nature of the underlying expenses.

7. The mere fact that a decision is made not to insure against losses that can reasonably be expected some time in the future does not necessitate accrual by the entity if it is not probable that an asset has been impaired or a liability incurred at the date of the financial statements.
Amounts Withheld or Retained by Company as Agent or Trustee

A reporting entity may, in the normal course of its business, withhold funds as an agent or trustee which will ultimately be paid to others. Amounts withheld or retained by an entity as trustee or agent shall be recorded as a liability when the salaries or other compensation are expensed (8(a and b)) or the funds are received (8(c, d and e)). Examples of such occurrences are:

a. As an employer, the reporting entity deducts and withholds federal and state income taxes, social security taxes, charitable contributions, savings plan deductions, garnishments, employee contributions to pension plans, employee share of group life and health insurance premiums, and other employee salary withholdings or deductions.

b. Amounts due under deferred compensation arrangements shall be accrued in accordance with the provisions of Issue Paper No. 14—Employers’ Accounting for Postretirement Benefits Other Than Pensions. Segregated funds (i.e., Rabbi trusts and similar arrangements) shall not be netted against the accrued liability unless the requirements of Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities are met.

c. Many reporting entities invest in commercial and residential mortgages. The entity may require the mortgagor to prepay real estate taxes and property insurance premiums which the entity will hold in escrow and pay when due.

d. Deposits held by a reporting entity in connection with leases of investment property.

e. Any other funds the reporting entity may receive and hold in a fiduciary capacity.

Remittances and Items Not Allocated

Cash receipts cannot always be identified for a specific purpose or, for other reasons, applied to a specific account when received. The reporting entity shall record a liability for these cash receipts when the funds are received. Such liability accounts are generally referred to as suspense accounts. Examples of such receipts include:

a. Premium payments received with the application for policies which have not yet been issued;

b. Premium payments in an amount different than the amount billed by the reporting entity;

c. Unidentified cash receipts.

Interest Payable

Interest payable includes interest on borrowed money as well as interest on real estate and approved interest on surplus notes. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. The amount to be reported is the amount which has accrued and is unpaid at the balance sheet date. The Property and Casualty Annual Statement includes a specific line to record accrued interest. Accrued interest for Life and Accident and Health Companies shall be recorded with the liability.

Payable to Parent, Subsidiaries and Affiliates

A liability shall be established for expenditures incurred on behalf of the reporting entity by a parent, affiliates, or subsidiaries or for amounts owed through other intercompany transactions. Examples of such expenses are executive salaries, workers compensation insurance premiums, pension contributions, etc. The liability shall be identified as an intercompany balance.
12. Reinsurance transactions are not considered liabilities of this nature and are covered in Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance and Issue Paper No. 75—Property and Casualty Reinsurance.

DISCUSSION

13. This issue paper adopts FASB Statement No. 116, Accounting for Contributions Received and Contributions made and AICPA Statement of Position 96-1, Environmental Remediation Liabilities.

14. The principles established are consistent with current statutory accounting principles and with Issue Paper No. 5. The requirement that liabilities be recorded when they are incurred is also consistent with the recognition principle described in the Statement of Concepts.

15. The liabilities addressed above are not specifically discussed in GAAP, however, they are considered liabilities and therefore are treated consistently with the GAAP guidance referenced in Issue Paper No. 5. The “Scope of the Statement” section of FASB Statement No. 5, Accounting for Contingencies, includes a reference to the fact that self-insurance is covered under the scope of the statement.

Drafting Notes/Comments
- Interest payable on surplus notes is addressed in Issue Paper No. 41—Surplus Notes.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
16. Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses accounting for other liabilities as follows:

**Amounts Withheld or Retained by Company as Agent or Trustee**

The life insurance company may, in the normal course of its business, withhold funds as an agent or trustee which will ultimately be paid to others. Funds held must be identified as to whom they are held for, as well as the amount, so that the liability can be confirmed by subsequent payments or confirmation by the payee. Examples of such occurrences are:

1. As an employer, the life insurance company deducts and withholds federal and state income taxes, social security taxes, employee contributions to pension plans, and employees’ share of group life and health insurance premiums. Such funds are recorded as a liability of the company at the time gross salaries are expensed and the liability is subsequently cleared by payment.

2. Many life insurance companies invest in commercial and residential mortgages. The company may require the mortgagor to prepay real estate taxes and property insurance premiums which the company will hold in escrow and pay when due.

3. Any other funds the company may receive and hold in a fiduciary capacity.

**Remittances and Items Not Allocated**

Cash receipts cannot always be identified for a specific purpose or, for other reasons, applied to a specific account when received. It is undesirable, costly, and imprudent for a company to delay depositing such receipts until the payment can be identified. Cash receipts should be deposited intact when received for good accounting control and to be available for investment by the company. It is customary for life insurance companies to maintain one or more liability accounts to record cash receipts which cannot be specifically allocated. Such liability accounts are generally referred to as suspense accounts. Examples of such receipts include:
1. Premium payments received with the application for policies which have not yet been issued;
2. Premium payments of amount different than the amount billed by the company;
3. Unidentified cash receipts.

Special attention should be given to the verification and clearance of suspense accounts. The outstanding suspense items should be aged. Any suspense item that has not been cleared after a specified time should be investigated. If premium payments are allowed to remain in suspense for a long period of time, it is possible that a policy might be improperly lapsed for nonpayment of premium or have nonforfeiture options or automatic premium loan options applied.

**Payable to Parent, Subsidiaries and Affiliates**

A liability should be established for amounts payable to a parent, subsidiary or affiliate for intercompany disbursements. Examples of such expenses are executive salaries, workers compensation insurance premiums, pension contributions, etc. The purpose of separating this liability from other accounts is to identify intercompany balances.

17. Chapter 13 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Other Liabilities, discusses accounting for other liabilities as follows:

Other liabilities are those liabilities not specifically covered by other chapters. Included in this category are the following annual statement captions:

- Borrowed Money
- Interest Payable
- Stockholder Dividends Declared and Unpaid
- Policyholder Dividends Declared and Unpaid
- Amounts Withheld or Retained by Company for Account of Others
- Provision for Reinsurance
- Excess of Statutory Reserves over Statement Reserves
- Net Adjustments in Assets and Liabilities Due to Foreign Exchange Rates
- Liability for Amounts Held Under Uninsured Accident and Health Plans
- Drafts Outstanding
- Payable to Affiliates
- Payable for Securities
- Debt Obligations of Employee Stock Ownership Plans
- Postretirement Benefits Other Than Pensions

**Interest Payable**

Interest payable includes interest on “Borrowed Money” as well as interest on real estate and surplus loans. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. Further treatment of funds held by a ceding company may be found in Chapter 22, Reinsurance.

The interest on “Borrowed Money” is also shown parenthetically as part of the caption of this liability item in the annual statement.

**Amounts Withheld or Retained by Company for Account of Others**

Items to be included under this classification are:

1. Amounts withheld from employee payrolls and unpaid at the balance sheet date. These include federal, state and city taxes and social security taxes, savings bonds deductions, charitable contributions, savings plan deductions, employee retirement plan
contributions, garnishments, group life and health insurance premiums, and other employee salary withholdings or deductions.

2. Deposits held by the company in connection with leases of investment property.

3. Escrow balances required of mortgagors for property taxes and insurance on real estate pledged for mortgages held by the company.

4. Any other funds the company holds in a fiduciary capacity for the account of others. This excludes reinsurance funds held, which are reported elsewhere and covered in Chapter 22-Reinsurance.

Payable to Affiliates

Amounts shown under this caption include unreimbursed expenditures on behalf of the company by a parent, affiliates, or subsidiaries or amounts owing through other intercompany transactions.

Reinsurance transactions are not normally reported on this line. For further information, see Chapter 22-Reinsurance.

Generally Accepted Accounting Principles

18. FASB Statement No. 5, Accounting for Contingencies

SCOPE OF THIS STATEMENT

56. Some respondents to the Exposure Draft proposed that the Statement not deal with accrual and disclosure of loss contingencies in general but, rather, only with the following three specific matters: “self-insurance,” risk of losses from catastrophes assumed by property and casualty insurance companies including reinsurance companies, and threat of expropriation.

57. The Board has concluded, however, that the broad issue of accrual and disclosure of loss contingencies should be dealt with in a single Statement, just as the Discussion Memorandum encompasses “the broad issue of accounting for future losses.” As the Discussion Memorandum stated, “future losses of all types presently known to affect enterprises and new types of future losses that may arise are conceptually included in the scope of this project.”

RISK OF FUTURE LOSS OR DAMAGE OF ENTERPRISE PROPERTY, INJURY TO OTHERS, DAMAGE TO THE PROPERTY OF OTHERS, AND BUSINESS INTERRUPTION

85. Some persons contend that the decision not to purchase insurance against losses that can be reasonably expected some time in the future (such as risk of loss or damage of enterprise property, injury to others, damage to the property of others, and business interruption) justifies periodic accrual for those losses without regard to whether it is probable that an asset has been impaired or a liability incurred at the date of the financial statements. As a basis for their position, they frequently cite the following factors: matching of revenue and expense, spreading the burden of irregularly occurring costs to successive generations of customers, and conservatism. They also believe that accrual of estimated losses from those types of risks improves the comparability of the financial statements of enterprises that purchase insurance. Some contend that a prohibition against periodic accrual for uninsured losses will force enterprises to purchase insurance coverage that would not otherwise be purchased.

86. In the Board’s judgment, however, the mere existence of risk, at the date of an enterprise’s financial statements, does not mean that a loss should be accrued. Anticipation of asset impairments or liabilities or losses from business interruption that do not relate to the current or a prior period is not justified by the matching concept.

87. The Board’s view regarding the contention that periodic accrual for uninsured losses is a way of providing protection against loss and improving comparability among enterprises that do
not purchase insurance, and the contention that prohibition of accrual will force enterprises to purchase insurance are discussed in paragraphs 61-66. The Board’s position regarding periodic accrual for uninsured risks and other loss contingencies on the grounds of spreading the burden of irregularly occurring costs to successive generations of customers or on the grounds of conservatism is discussed in paragraphs 81-84.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13
- Issue Paper No. 14—Employers’ Accounting for Postretirement Benefits Other Than Pensions
- Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities
- Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance
- Issue Paper No. 75—Property and Casualty Reinsurance

Generally Accepted Accounting Principles
- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 116, Accounting for Contributions Received and Contributions Made
- AICPA Statement of Position 96-1, Environmental Remediation Liabilities

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 97

Underwriting Pools and Associations Including Intercompany Pools

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Underwriting pools and associations can be categorized as follows: involuntary, voluntary, and intercompany.

2. Involuntary pools represent a mechanism employed by states to provide insurance coverage to those with higher than average probability of loss who otherwise would be excluded from obtaining coverage. Reporting entities are generally required to participate in the underwriting results, including premiums, losses, expenses, and other operations of involuntary pools, based on their proportionate share of similar business written in the state. Involuntary plans are also referred to as residual market plans, involuntary risk pools, and mandatory pools.

3. Voluntary pools are similar to involuntary pools except they are not state mandated and a reporting entity participates in the pool voluntarily. In addition, voluntary pools are not limited to the provision of insurance coverage to those with higher than average probability of loss, but often are used to provide greater capacity for risks with exceptionally high levels of insurable values (e.g., aircraft, nuclear power plants, refineries, and offshore drilling platforms).

4. Intercompany pooling relates to business which is pooled among affiliated entities who are party to a pooling arrangement.

5. Current statutory accounting provides limited guidance on accounting for a reporting entity’s participation in underwriting pools and associations. Although it is not specifically stated in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices & Procedures Manuals), certain annual statement schedules do require that the reporting entity’s participation in the pools’ underwriting results be recorded on a gross basis. However, the guidance does not address whether participation in the pools should be recorded using accrual or cash basis accounting. Reporting entities are currently utilizing both approaches. GAAP guidance related to underwriting pools and associations is limited to FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113). FAS 113 states that involuntary plans are included within the scope of the statement; therefore the reinsurance activity should be recorded on a gross basis.

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

SUMMARY CONCLUSION

7. Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), defines a liability and states that the definition “includes but is not limited to liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims).” Issue Paper No. 5 requires liabilities to be recorded on a reporting entity’s financial statements when incurred.
8. Participation in a pool may be on a joint and several basis, i.e., in addition to a proportional share of losses and expenses incurred by the pool, participants will be responsible for their share of any otherwise unrecoverable obligations of other pool participants. In certain instances, one or more entities may be designated as servicing carriers for purposes of policy issuance, claims handling, and general administration of the pooled business, while in other cases a pool manager or administrator performs all of these functions and simply bills pool participants for their respective shares of all losses and expenses incurred by the pool. In either case, liabilities arising from pooled business are generally incurred on a basis similar to those associated with non-pooled business, and should therefore be treated in a manner consistent with the guidelines set forth in Issue Paper No. 5 and in paragraph 7 of this issue paper.

9. Intercompany pooling arrangements involve establishment of a conventional quota share reinsurance agreement under which all of the pooled business is ceded to the lead entity and then retroceded back to the pool participants in accordance with their stipulated shares. In such arrangements, only the policy issuing entity has direct liability to its policyholders or claimants; other pool participants are liable as reinsurers for their share of the issuing entity’s obligations. Although participants may use different assumptions (e.g., discount rates) in recording transactions, the timing of recording transactions shall be consistently applied by all participants.

10. Underwriting results shall be accounted for on a gross basis whereby the participant’s portion of premiums, losses, expenses, and other operations of the pools are recorded separately in the financial statements rather than netted against each other. Premiums and losses shall be recorded as direct, assumed, and/or ceded as applicable. If the reporting entity is a direct writer of the business premiums, losses shall be recorded as directly written and accounted for in the same manner as other business which is directly written by the entity. To the extent that premium is ceded to a pool, premiums and losses shall be recorded in the same manner as any other reinsurance arrangement. A reporting entity who is a member of a pool shall record its participation in the pool as assumed business as in any other reinsurance arrangement.

11. Equity interests in, or deposits receivable from, a pool represent cash advances to provide funding for operations of the pool. These are admitted assets and shall be recorded separately from receivables and payables related to a pool’s underwriting results. Receivables and payables related to underwriting results should be accounted for in accordance with the guidance in paragraphs 7 to 10, above. If, in accordance with Issue Paper No. 5, it is probable that these receivables are uncollectible, any uncollectible amounts shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible but is not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

12. If a reporting entity is part of a group of affiliated entities which utilizes a pooling arrangement under which the pool participants cede substantially all of their direct and assumed business to the pool, the financial statements shall include:

   a. A description of the basic terms of the arrangement and the related accounting;

   b. Identification of the lead entity and of all affiliated entities participating in the intercompany pool (include NAIC Company Codes) and indication of their respective percentage shares of the pooled business;

   c. Description of the lines and types of business subject to the pooling agreement;

   d. Description of cessions to non-affiliated reinsurers of business subject to the pooling agreement, and indication of whether such cessions were prior to or subsequent to the cession of pooled business from the affiliated pool members to the lead entity;
e. Identification of all pool members which are parties to reinsurance agreements with non-affiliated reinsurers covering business subject to the pooling agreement and which have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements;

f. Explanation of any discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the lead entity and corresponding entries on the assumed and ceded reinsurance schedules of other pool participants;

g. Description of intercompany sharing, if other than in accordance with the pool participation percentage, of the Provision for Reinsurance (Schedule F, Part 7) and the write-off of uncollectible reinsurance.

DISCUSSION

13. This issue paper applies Issue Paper No. 5 to underwriting pools and associations.

14. There are a variety of types of underwriting pools and associations. Examples include, but are not limited to Assigned Risk Plans, Joint Underwriting Associations, Reinsurance Pools, Fair Access to Insurance Requirements Plans, Comprehensive Health Insurance Plans, and Workers Compensation Pools.

15. Certain underwriting pools and associations, such as Assigned Risk Plans, require the reporting entity to accept a share of the undesirable risks based on the percent of the premium written in that state. The reporting entity is then responsible for collecting premiums and paying claims on policies issued to these applicants. Other underwriting pools and associations, such as Joint Underwriting Associations, require all entities in the state to participate in the underwriting results, however, a servicing company is designated to issue the policies and pay the claims for these risks on behalf of the pool.

16. Current statutory practice related to underwriting pools and associations is varied. A “pay-as-you-go” (cash basis) approach has been adopted by many entities. This issue paper rejects that treatment because it is inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts. It is also inconsistent with the accounting principles set forth in Issue Paper No. 5. With respect to conservatism, the Statement of Concepts states:

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management...In order to provide a margin of protection to policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

17. With respect to recognition, the Statement of Concepts states that:

“Liabilities require recognition as they are incurred...Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.”

18. Many reporting entities have adopted the practice of netting the underwriting results related to their participation in underwriting pools and associations. Although the Life/A&H and P&C Accounting Practices and Procedures Manuals do not specifically state that the reporting entity’s participation in the pool’s underwriting results shall be recorded on a gross basis, the Annual Statement Instructions for Property and Casualty Insurance Companies require a separate disclosure of “the net reserves for losses and expenses for the entity’s share of underwriting pools’ and associations’ unpaid loss and expenses which are included in reserves.” The instructions also require that reinsurance assumed from and ceded to underwriting pools and associations be disclosed separately thereby establishing the requirement to record reinsurance on a gross basis.
19. All forms of underwriting pools and associations should be accounted for consistently. It would be inconsistent to require reporting entities to account for underwriting results related to assigned risk plans on a gross basis and underwriting results related to joint underwriting associations on a net basis. Accounting for the plans consistently enables regulators to more effectively compare results of the individual entities participating in the plans.

20. The consistency requirement of paragraph 19 is supported by the Statement of Concepts which states that:

   The regulator's need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

21. There is no specific GAAP guidance related to underwriting pools and associations other than in FAS 113 which states that involuntary risk pools are included within the scope of the statement and thereby requires the reinsurance activity to be recorded on a gross basis.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
22. The P&C Accounting Practices and Procedures Manual, Chapter 14, *Premiums*, discusses the following:

   **Underwriting Pools, Associations, and Syndicates**
   Companies also participate as members of an underwriting pool, association, or syndicate organized to provide special insurance coverages. Operating results, including the applicable premiums, are distributed to member companies based on their prescribed share.

   Usually, statements are received by the company showing the total premiums written, as well as the member company’s participation. These premiums are recorded on a summary basis (usually by line of business) as direct or assumed business depending on the requirements of the particular association.

23. The P&C Accounting Practices and Procedures Manual, Chapter 22, *Reinsurance*, discusses the following:

   Fronting arrangements, servicing carrier business, and pools and association business are often accomplished using reinsurance contracts. The guidance included in this chapter also applies to these types of contracts, except as specifically exempted.

24. The Annual Statement Instructions for Property and Casualty Insurance Companies, General Section, discusses the following requirements related to the actuarial opinion:

   8. The scope paragraph should contain a sentence such as the following:

   "I have examined the actuarial assumptions and methods used in determining reserves listed below, as shown in the Annual Statement of the Company as prepared for filing with state regulatory officials, as of December 31, 19__."
The paragraph should list items and amounts with respect to which the actuary is expressing an opinion. The list should include but not necessarily be limited to:

A. Reserve for Unpaid Losses (Page 3, Line 1);
B. Reserve for Unpaid Loss Adjustment Expenses (Page 3, Line 2);
C. Reserve for Unpaid Losses - Direct and Assumed (Schedule P, Part 1, Totals from Cols. 13 and 15); and
D. Reserve for Unpaid Loss Adjustment Expenses - Direct and Assumed (Schedule P, Part 1, Totals from Cols. 17, 19, and 22).

If the actuary includes the Excess of Statutory over Statement Reserves to the above list, the actuary must also opine on the reserves excluding this amount.

9. The actuary should state that the items in paragraph 8, on which he or she is expressing an opinion, reflect the following items:

A. ...
B. ...
C. The net reserves for losses and expenses for the company’s share of voluntary and involuntary underwriting pools’ and associations’ unpaid losses and expenses which are included in reserves shown on Page 3 - Liability, Surplus and Other Funds, Lines 1 and 2, $__________.

11. The actuary should comment in the scope section on each of the following topics, describing the effect of each on loss or loss expense reserves: ...underwriting pools or associations, ...

25. The Annual Statement Instructions for Property and Casualty Insurance Companies, Section referring to Assets, discusses the following disclosure requirement:

Line 17 - Equities and Deposits in Pools and Associations

In the event that the insurer has equity in, or deposits receivable from, underwriting associations, pools, etc., the equity interests and deposits receivable should be reported here.

26. The Annual Statement Instructions for Property and Casualty Insurance Companies, Section referring to Schedule F-Part 1-Assumed Reinsurance and Schedule F-Part 3-Ceded Reinsurance, requires reinsurance assumed from and ceded to mandatory pools and associations be disclosed separately from voluntary pools and associations.

27. The Property and Casualty Reinsurance Study Group of the Accounting Practices and Procedures (EX4) Task Force adopted the following disclosure requirements for intercompany pooling arrangements at its September 29, 1996 meeting.
PROPOSED INSTRUCTIONS
PROPERTY/CASUALTY ANNUAL STATEMENT FOOTNOTE

Intercompany Pooling Arrangements

Instruction:

If the company is part of a group of affiliated insurers which utilizes a pooling arrangement that affects the solvency and integrity of the insurer’s reserves under which the pool participants cede substantially all of their direct and assumed business to the pool, describe the basic terms of such arrangement[s] and the related accounting. The disclosure should include:

- Identification of the lead company and of all affiliated companies participating in the intercompany pool (include NAIC Company Codes) and indication of their respective percentage shares of the pooled business.

- Description of the lines and types of business subject to the pooling agreement.

- Description of cessions to non-affiliated reinsurers of business subject to the pooling agreement, and indication of whether such cessions were prior to or subsequent to the cession of pooled business from the affiliated pool members to the lead company.

- Identification of all pool members which are parties to reinsurance agreements with non-affiliated reinsurance reinsurers covering business subject to the pooling agreement and which have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements.

- Explanation of any discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the lead company and corresponding entries on the assumed and ceded reinsurance schedules of other pool participants.

- Description of intercompany sharing, if other than in accordance with the pool participation percentage, of the Provision for Reinsurance (Schedule F, Part 7) and the write–off of uncollectible reinsurance.

Illustration

ALTERNATIVE 1: EXTERNAL REINSURANCE PRIOR TO POOLING

The Company participates in an intercompany reinsurance pooling arrangement in which The ABC Insurance Company is the lead company. Under the terms of the arrangement, all of the property-casualty underwriting risks of the intercompany pool participants except other accident & health are reinsured with the lead company after each individual company’s external reinsurance is transacted among third parties. This pool of property-casualty net underwriting risks is then retroceded from the lead company to the other non-lead pool participants based on pool participation percentages.

The names, NAIC company codes and pool participation percentages of the ABC Group’s intercompany pooling arrangement are as follows:

<table>
<thead>
<tr>
<th>Pool Participant</th>
<th>NAIC Company Code</th>
<th>Pool Participation %</th>
</tr>
</thead>
<tbody>
<tr>
<td>The ABC Insurance Company</td>
<td>000001</td>
<td>75%</td>
</tr>
<tr>
<td>The ABC Casualty Company</td>
<td>0000100002</td>
<td>10%</td>
</tr>
<tr>
<td>The ABC Indemnity Company</td>
<td>000003</td>
<td>10%</td>
</tr>
<tr>
<td>ABC Fire Insurance Company</td>
<td>000004</td>
<td>5%</td>
</tr>
</tbody>
</table>
ALTERNATIVE 2: EXTERNAL REINSURANCE AFTER POOLING

The Company participates in an intercompany reinsurance pooling arrangement in which The ABC Insurance Company is the lead company. Under the terms of the arrangement, all of the property–casualty underwriting risks of the intercompany pool participants except other accident & health are reinsured with the lead company. After reinsurance is transacted among third parties by the lead company, the remaining pool of property-casualty underwriting risks is then retroceded to the other non–lead pool participants based on pool participation percentages.

The names, NAIC company codes and pool participation percentages of the ABC Group’s intercompany pooling arrangement are as follows:

<table>
<thead>
<tr>
<th>Pool Participant</th>
<th>NAIC Company Code</th>
<th>Pool Participation %</th>
</tr>
</thead>
<tbody>
<tr>
<td>The ABC Insurance Company</td>
<td>00001</td>
<td>75%</td>
</tr>
<tr>
<td>The ABC Casualty Company</td>
<td>0000100002</td>
<td>10%</td>
</tr>
<tr>
<td>The ABC Indemnity Company</td>
<td>00003</td>
<td>10%</td>
</tr>
<tr>
<td>ABC Fire Insurance Company</td>
<td>00004</td>
<td>5%</td>
</tr>
</tbody>
</table>

Generally Accepted Accounting Principles

29. FAS 113 discusses the following:

50. Several respondents questioned whether servicing carriers for involuntary risk pools should be included in the Statement’s scope. Servicing carriers generally retain the primary obligation to the policyholder and have no right to offset claim liabilities against amounts due from other pool participants. Although the credit risk associated with involuntary pools may be reduced because of the pool membership’s joint and several liability, the servicing carrier is still dependent on the ability of other pool members to pay their proportionate share of claims. State authorities oversee such pools and may act to support the solvency of pool, but that action generally is voluntary. The Board concluded that it was unable to effectively distinguish servicing carrier business from other types of reinsurance for accounting purposes. Separate presentation or disclosure of servicing carrier activity is not precluded by this Statement.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 14 and 22
- The Annual Statement Instructions for Property and Casualty Insurance Companies
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets

Generally Accepted Accounting Principles
- AICPA Audit and Accounting Guide: Audits of Property and Casualty Insurance Companies, Chapter 1, Nature, Conduct, and Regulation of the Business, Section 1.08
- FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 99

Nonapplicable GAAP Pronouncements

STATUS
Updated for actions taken by the Statutory Accounting Principles Working Group through December 2010.

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This statement addresses Generally Accepted Accounting Principles (GAAP) pronouncements that are nonapplicable due to one of the following reasons:

   a. The pronouncement does not relate to the insurance industry;
   
   b. The pronouncement is not within the objectives of statutory accounting;
   
   c. The pronouncement would not add a substantive amount of guidance to statutory accounting due to the narrow scope of the topic;
   
   d. The pronouncement relates to transition of a previously issued GAAP pronouncement.

SUMMARY CONCLUSION

2. GAAP pronouncements not considered applicable to the NAIC codification project are summarized as follows:

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**DISCUSSION**

3. This issue paper rejects the nonapplicable GAAP pronouncements listed in the Summary Conclusion.

**Drafting Notes/Comments**

None

**RELEVANT LITERATURE**

**Statutory Accounting**

None

**State Regulations**

- No additional guidance obtained from state statutes or regulations
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Statutory Issue Paper No. 100

Health Care Delivery Assets—Supplies, Pharmaceuticals and Surgical Supplies, and Durable Medical Equipment

STATUS
Finalized June 23, 1998

Type of Issue
Health Entities

SUMMARY OF ISSUE

1. This issue paper applies only to reporting entities which directly provide health care services to subscribers, members or policyholders. Such providers acquire and retain assets not directly addressed in current statutory guidelines. These assets, commonly referred to as “health care delivery assets”, are assets used in connection with the direct delivery of health care services in facilities owned or operated by the reporting entity and include supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

2. The purpose of this issue paper is to establish statutory accounting principles for health care delivery assets—supplies, pharmaceuticals and surgical supplies, and durable medical equipment that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Supplies, pharmaceuticals and surgical supplies, and durable medical equipment meet the definition of assets established in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Pharmaceuticals and surgical supplies, and durable medical equipment held by reporting entities and used for the direct delivery of health care services are assets which are used to fulfill policyholder obligations within the meaning of Issue Paper No. 4 and are admitted assets to the extent that they conform to the requirements of this issue paper.

4. The reporting entity shall maintain a control system that provides for identification of quantities on hand and appropriate valuation (lower of cost or market) of supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

5. Supplies except for pharmaceuticals and surgical supplies discussed in paragraph 6 (e.g., linens, uniforms and garments, food and other commodities, and housekeeping, maintenance, and office supplies) shall be nonadmitted assets.

6. Pharmaceutical and surgical supplies (e.g. drugs, surgical items (such as implants), and medical dressings) used directly in the treatment of medical conditions shall be admitted assets.

7. Durable medical equipment includes consumable or salable equipment such as wheelchairs, crutches and braces, that is generally classified as inventory, and is of a nature that it may be reused. Subscribers, members or policyholders may utilize durable medical equipment on a temporary basis and later return the equipment to the provider. The provider shall recognize the diminution in value, if any, as a result of use of such equipment.
8. In accordance with the reporting entity’s capitalization policy, immaterial amounts of medical supplies, pharmaceuticals and surgical supplies, and durable medical equipment may be expensed when purchased.

DISCUSSION

9. Supplies as defined in this issue paper are nonadmitted assets because they are consumed in the normal operations of a hospital or medical facility and would generally have limited or no value in the event of liquidation.

10. Pharmaceuticals and surgical supplies, and durable medical equipment are admitted assets as defined in this issue paper because they are used to fulfill benefit requirements, they are tightly controlled and the nature of such items would generally permit the recovery of costs upon liquidation.

11. This issue paper rejects the AICPA Audit and Accounting Guide: Health Care Organizations.

12. The statutory accounting principles established in this issue paper are consistent with the recognition concept in the Statement of Concepts which states:

   The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise’s ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

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

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

13. The Health Maintenance Organization Model Act, dated July 1995 states the following:

   Section 5. Powers of Health Maintenance Organizations
   
   A. The powers of a health maintenance organization include, but are not limited to, the following:

   (1) The purchase, lease, construction, renovation, operation or maintenance of hospitals, medical facilities, or both, and their ancillary equipment, and property reasonably required for its principal office or for purposes necessary to the transaction of the business of the organization;

   Section 12. Investments

   With the exception of investments made in accordance with Section 5A(1), the funds of a health maintenance organization shall be invested only in accordance with [cite section of law or regulation implementing the NAIC Health Maintenance Organization Investment Guidelines.]
Generally Accepted Accounting Principles
14. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

6.02. Supplies usually are not material to the financial position of health care organizations. However, because of the volume of supply transactions, they may materially affect operations. Supplies typically include medical and surgical supplies; pharmaceuticals; linens; uniforms, and garments; food and other commodities; and housekeeping, maintenance, and office supplies.

6.04. Accounting for property and equipment, supplies, and other assets of health care organizations is similar to that used by other business organizations.

Other Sources of Information
15. The NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996 conducted by the Risk-Based Capital Task Force surveyed the state insurance departments that regulate HMOs to determine if and to what degree that they allow HMOs to admit health care delivery assets. Responses from 38 state insurance departments indicated that the vast majority admit such assets at book value. A number of state insurance departments noted that they do place varying limits on the amount of certain health care delivery assets that can be admitted. However, none of the respondent states indicated that they did not admit such assets.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Health Maintenance Organization Model Act, dated July 1995
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets

Generally Accepted Accounting Principles
- The AICPA Audit and Accounting Guide: Health Care Organizations

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

Other Sources of Information
- NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996
Statutory Issue Paper No. 101

Health Care Delivery Assets—Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities

STATUS
Finalized June 23, 1998

Type of Issue:
Health Entities

SUMMARY OF ISSUE

1. This issue paper applies only to reporting entities which directly provide health care services to subscribers, members or policyholders. Such providers acquire and retain assets not directly addressed in current statutory guidelines. These assets commonly referred to as “health care delivery assets”, are assets used in connection with the direct delivery of health care services in facilities owned or operated by the reporting entity and include furniture, medical equipment and fixtures and leasehold improvements.

2. Furniture, medical equipment and fixtures used in connection with the direct provision of health care services include diagnostic equipment, laboratory equipment, patient monitoring equipment, hospital beds, examining tables, and operating room equipment.

3. The purpose of this issue paper is to establish statutory accounting principles for health care delivery assets - furniture, medical equipment and fixtures and leasehold improvements in health care facilities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Furniture, medical equipment and fixtures, and leasehold improvements in health care facilities owned or operated by the reporting entity meet the definition of assets established in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Furniture, medical equipment and fixtures, and leasehold improvements held by health reporting entities and used for the direct delivery of health care services are admitted assets to the extent that they conform to the requirements of this issue paper. Furniture, fixtures and equipment, and leasehold improvements which are not used in the direct delivery of health care (e.g., for administrative activities including claims processing, billing, and maintenance of medical records) are nonadmitted assets and are addressed in Issue Paper No. 19—Furniture, Fixtures, and Equipment and Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee, respectively.

5. These assets shall be depreciated over their estimated useful lives but for a period not to exceed three years, except for a leasehold improvement which shall be amortized against net income over the shorter of its estimated useful life or the remaining life of the original lease excluding renewal or option periods, using methods detailed in Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements.

6. In accordance with the reporting entity’s capitalization policy, immaterial amounts of furniture, medical equipment and fixtures, and leasehold improvements may be expensed when purchased.
DISCUSSION

7. Furniture, medical equipment and fixtures and leasehold improvements in health care facilities owned or operated by the reporting entity used in the direct delivery of health care are admitted assets as defined in this issue paper because they are used to fulfill benefit requirements.

8. The AICPA Audit and Accounting Guide: Health Care Organizations is rejected in Issue Paper No. 100—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, and Durable Medical Equipment.

9. The statutory accounting principles established in this issue paper are consistent with the recognition concept in the Statement of Concepts which states:

   The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

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

Drafting Notes/Comments
- Land and building, including health care facilities, are addressed in Issue Paper No. 23—Property Occupied by the Company.
- Electronic Data Processing Equipment and Software are addressed in Issue Paper No. 16—Electronic Data Processing Equipment and Software.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
10. The Accounting Practices and Procedures Manual for Health Maintenance Organizations (Chapter 5, Other Admitted Assets) states:

   INVESTMENTS INVOLVING EQUIPMENT

   The statutory method of accounting for equipment arrangements is governed largely by the form of the agreement to which the HMO is a party.

11. The Accounting Practices and Procedures Manual for Health Maintenance Organizations (Chapter 6, Nonadmitted Assets) states:

   COMMON EXAMPLES

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

   (6) net book value of equipment and furniture (except certain electronic data processing equipment and medical equipment)
12. The Health Maintenance Organization Model Act, dated July 1995 states the following:

Section 5. Powers of Health Maintenance Organizations

A. The powers of a health maintenance organization include, but are not limited to, the following:

(1) The purchase, lease, construction, renovation, operation or maintenance of hospitals, medical facilities, or both, and their ancillary equipment, and property reasonably required for its principal office or for purposes necessary to the transaction of the business of the organization;

Section 12. Investments

With the exception of investments made in accordance with Section 5A(1), the funds of a health maintenance organization shall be invested only in accordance with [cite section of law or regulation implementing the NAIC Health Maintenance Organization Investment Guidelines.]

Generally Accepted Accounting Principles

13. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

6.01. Health care organizations use various types of property and equipment. Those assets may be material to the financial position of institutional health organizations, such as hospitals and nursing homes. Typical accounts used to record property and equipment transactions are land, land improvements, buildings and improvements, leasehold improvements, equipment (fixed and movable), leased property and equipment, accumulated depreciation and amortization, and construction in progress.

6.04. Accounting for property and equipment, supplies, and other assets of health care organizations is similar to that used by other business organizations.

6.05. Depreciation and amortization of property and equipment are recorded in conformity with GAAP. Useful lives assigned to depreciable assets should be reasonable, based on the circumstances. The American Hospital Association publishes useful guidelines for classifications and estimated useful lives for property and equipment used by hospitals. Those guidelines also may be useful to other health care organizations. If there is a potential that an asset is impaired, health care organizations should consider the guidance in FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of.

Other Sources of Information

14. The NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996 conducted by the Risk Based Capital Task Force surveyed the state insurance departments that regulate HMOs to determine if and to what degree that they allow HMOs to admit health care delivery assets. Responses from 38 state insurance departments indicated that the vast majority admit such assets at book value. A number of state insurance departments noted that they do place varying limits on the amount of certain health care delivery assets that can be admitted. However, none of the respondent states indicated that they did not admit such assets.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- The Accounting Practices and Procedures Manual for Health Maintenance Organizations, Chapter 5, Other Admitted Assets and Chapter 6, Nonadmitted Assets
- Health Maintenance Organization Model Act, dated July 1995
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
Generally Accepted Accounting Principles
- The AICPA Audit and Accounting Guide: Health Care Organizations

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

Other Sources of Information
- NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996
Statutory Issue Paper No. 103

Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer Through a Protected Cell

STATUS
Finalized June 13, 2000

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Insurance–linked securities are fully funded corporate securities with special language that requires the securityholder to forgive or defer some or all payments of interest or principal if actual insurance losses surpass a specified amount, or trigger event. Should a triggering event occur, an insurer or reinsurer that issued insurance-linked securities can pay claims with all or a portion of the securityholder proceeds. To the extent that securityholders proceeds are at risk of loss, the insurer or reinsurer can write down its liability for the securities, and recognize a surplus benefit in an equal amount.

2. Chapter 1 of the Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies does not specifically address accounting for the issuers of insurance-linked securities issued through a protected cell. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133 - Accounting for Derivative Instruments and Hedging Activities (FAS 133) dictates that these types of contracts would be accounted for as reinsurance.

3. The purpose of this issue paper is to provide guidance for protected cells that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definitions

4. The Protected Cell Model Act (included in its entirety in the Relevant Statutory Accounting and GAAP Guidance section) includes a complete listing of definitions used in this issue paper.

General

5. An insurance-linked security can be issued by the insurer through a protected cell for purchase by investors. A protected cell is retained within the insurance or reinsurance company and is used to insulate the proceeds of the securities offering from the general business risks of the insurer, granting an additional comfort level for investors of the securitized instrument. The insurance exposures that have been securitized by the insurance-linked security are attributed to the protected cell.

6. Under the terms of the security, the principal may be paid to the investor on a specified maturity date, with interest, unless a trigger event occurs. The proceeds of the security offering will collateralize (i) the issuer's obligation under an insurance or reinsurance agreement if a trigger event occurs and (ii) the issuer's obligation to repay the security if a trigger event does not occur.

7. If the trigger event takes place before a specified date, the issuer is relieved of some or its entire obligation to repay the securityholders, and the investor incurs a loss of some or all of its investment. The security must be issued with an indemnity trigger.
8. In an insurance-linked security, the insurer that originated the transaction has hedged its portfolio of insurance risks by transferring certain of those risks to the securityholders. Should the triggering event occur, the issuer would incur a loss that would be partly offset by the amount of liability to securityholders from which it is relieved. This issue paper provides statutory accounting guidance solely for indemnity triggered insurance securitization transactions conducted through a protected cell.

Accounting for Prefunded Insurance-Linked Securities for Business Attributed to the Protected Cell from the General Account

General Account Reporting

9. Activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, and claims processing are activities of the insurance company distinct from the protected cell and shall be accounted for as transactions of the general account.

10. Amounts paid to the protected cell for underwriting risks, which ultimately will be securitized by the protected cell, shall be reported separately as a reduction of written and earned premiums in the current period general account’s statement of income. This premium is earned by the general account in accordance with Issue Paper No. 53—Property Casualty Contracts—Premiums.

11. At the maturity of the protected cell all assets and liabilities of the protected cell are distributed based on the contractual agreement with the securityholders. If after this distribution assets still reside in the protected cell, these assets shall be attributed to the general account and recognized as an adjustment to surplus.

12. Insurance claim liabilities arising from past insurable events attributed to the protected cell account from the general account shall be accounted for as retro-active reinsurance as prescribed in Issue Paper No. 75—Property and Casualty Reinsurance.

13. General account recoverables from the protected cell as a result of an indemnity based securitized event, shall be recognized separately as a reduction of gross losses and loss expenses incurred in the current period general account’s statement of income. General account recoverables from the protected cell on unpaid reported and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses in the general account’s balance sheet. Recoverables from the protected cell shall not exceed the assets carried at fair value in the protected cell.

14. The general account shall include an aggregate write-in for the total assets and an aggregate write-in for liabilities of any protected cell which it maintains. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated.

Protected Cell Reporting

15. The protected cell annual statement is concerned with the investment activities and obligations relating to insurance-linked securities attributed to that protected cell. As a result, the protected cell statement shall report only the financial activities of the protected cell and shall not include general account expenses related to insurance activities which are recorded for in the general account.

16. The protected cell shall record premium income for transactions attributed to it by the general account as income reported in the protected cell’s statement of income. This premium attribution is earned by the protected cell in accordance with Issue Paper No. 53—Property and Casualty Premium.
17. The obligation from the issuance of the insurance-linked security is recorded as Funds Held Under Securitization Agreement, a liability on the protected cell balance sheet which is reported at its contractual value which will be the lower of the scheduled amount to be repaid to investors or the fair value of the investments in the protected cell. All protected cell assets shall be reported at fair value. Interest expenses payable to securityholders associated with the protected cell investment operations shall be deducted in the determination of net operating income of the cell. Net investment income and realized capital gains and losses relating to the investment operations of the protected cell are recorded as net investment income. Payables to the general account shall not exceed the assets carried at fair value in the protected cell.

18. Changes in both (i.) the fair value of the protected cell invested assets and (ii.) the protected cell contractual (or discounted) value of liabilities to investors shall be reported as an unrealized gain/loss in the equity section of the protected cell balance sheet.

19. When the trigger event occurs with respect to the underlying exposures attributed to the protected cell, the protected cell shall record the appropriate incurred losses in its current period statement of income. Correspondingly, the Funds Held Under Securitization Agreement shall be reduced and offset by gross losses incurred in the current period Statement of Income. The applicable funds to cover the subject exposure are then attributed to the general account via a balance sheet account, “Due to/from the General Account.”

20. If the trigger event does not take place on or before the contractual maturity date, the protected cell repays the bond principal as prescribed in the debt contract by reducing Funds Held Under Securitization Agreement.

**Disclosures**

**General Account**

21. Prior to the adoption of formal blanks changes by the NAIC Blanks Task Force, the general account shall reflect all activities with its protected cells as an aggregate write-in in its statutory balance sheet and income statement. The general account shall also disclose in its notes to the financial statements the types and amounts of exposures /risks attributed to each of its protected cells.

**Protected Cells**

22. Each protected cell of a protected cell company shall prepare and submit to all states where the protected cell company is licensed and the NAIC the following supplemental financial information:

   a. Balance Sheet
   b. Income Statement
   c. Statement of Cash Flows
   d. Investment Schedules as typically required for a property/casualty insurer
   e. Schedule P

**DISCUSSION**

23. This issue paper prescribes the accounting for the issuance of insurance-linked securities issued by a property and casualty insurer through a protected cell. This guidance was adopted by the Insurance Securitization Working Group of the Financial Condition (E) Committee in 1999. The Emerging Accounting Issues Working Group adopted the guidance as “NAIC Preferred Accounting Treatment” in October 1999. This issue is specifically scoped out of FAS 133, and therefore the protected cell concept is unique to statutory accounting.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
24. In October 1999, the Emerging Accounting Issues Working Group adopted as “NAIC Preferred Accounting Treatment” the issue summary titled Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell. The guidance included in the Summary Conclusion section of this issue paper is consistent with the previously adopted issue summary.

Generally Accepted Accounting Principles
25. The following language is included in FAS No. 133, Accounting for Derivative Instruments and Hedging Activities:

192. Example 26: Disaster Bond. A bond that pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.

Scope Application: A disaster bond can be viewed as a fixed-rate bond combined with a conditional exchange contract (an option). The investor receives an additional coupon interest payment in return for giving the issuer an option indexed to industry loss experience on a specified disaster. Because the option contract is indexed to the specified disaster experience, it cannot be viewed as being clearly and closely related to an investment in a fixed-rate bond. Therefore, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.

However, if the “embedded derivative” entitles the holder of the option (that is, the issuer of the disaster bond) to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk (including the liability for insurance claims payable due to the specified disaster) as a result of an identified insurable event (refer to paragraph 10(c)(2)), a separate instrument with the same terms as the “embedded derivative” would not meet the Statement's definition of a derivative in paragraphs 6–11. In that circumstance, because the criterion in paragraph 12(c) would not be met, there is no embedded derivative to be separated from the host contract, and the disaster bond would not be subject to the requirements of this Statement. The investor is essentially providing a form of insurance or reinsurance coverage to the issuer.

26. This issue paper only contemplates transactions with an indemnity-based trigger, as such they would be excluded from FAS 133 and accounting for as reinsurance under FAS 113 – Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.

Other Sources
27. The Insurance Securitization Working Group developed the following Protected Cell Model Act. Details of considerations made in drafting this model act can be found in the minutes of the working group.

PROTECTED CELL COMPANY MODEL ACT

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Section 8. No Transaction of an Insurance Business
Section 9. Authority to Adopt Regulations
Section 10. Effective Date

This Act may be cited as the “Protected Cell Company Act.”

Section 2. Purpose

This Act is adopted to provide a basis for the creation of protected cells by a domestic insurer as one means of accessing alternative sources of capital and achieving the benefits of insurance securitization. Investors in fully funded insurance securitization transactions provide funds that are available to pay the insurer’s insurance obligations or to repay the investors or both. The creation of protected cells is intended to be a means to achieve more efficiencies in conducting insurance securitizations.

Drafting Note: Under the terms of the typical debt instrument underlying an insurance securitization transaction, prepaid principal is repaid to the investor on a specified maturity date with interest, unless a trigger event occurs. The insurance securitization proceeds secure both the protected cell company’s insurance obligations if a trigger event occurs, as well as the protected cell company’s obligation to repay the insurance securitization investors if a trigger event does not occur. Insurance securitization transactions have been performed through alien companies in order to utilize efficiencies available to alien companies that are not currently available to domestic companies. This Act is adopted in order to create more efficiency in conducting insurance securitization, to allow domestic protected cell companies easier access to alternative sources of capital, and to promote the benefits of insurance securitization generally.

Section 3. Definitions

For the purposes of this Act, the following terms shall have the following meanings:

A. “Domestic insurer” means an insurer domiciled in the State of [insert state].

B. “Fully funded” means that, with respect to any exposure attributed to a protected cell, the fair value of the protected cell assets, on the date on which the insurance securitization is effected, equals or exceeds the maximum possible exposure attributable to the protected cell with respect to such exposures.

C. “General account” means the assets and liabilities of a protected cell company other than protected cell assets and protected cell liabilities.

D. “Indemnity trigger” means a transaction term by which relief of the issuer’s obligation to repay investors is triggered by its incurring a specified level of losses under its insurance or reinsurance contracts.

E. “Fair value” of an asset (or liability) means the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a
discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm’s-length transaction. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

F. “Non-indemnity trigger” means a transaction term by which relief of the issuer’s obligation to repay investors is triggered solely by some event or condition other than the individual protected cell company incurring a specified level of losses under its insurance or reinsurance contracts.

G. “Protected cell” means an identified pool of assets and liabilities of a protected cell company segregated and insulated by means of this Act from the remainder of the protected cell company’s assets and liabilities.

Drafting Note: This term is meant to reference identification of statutorily segregated assets and liabilities through the accounting function. By attributing certain assets and liabilities to a protected cell on the protected cell company’s books and records, and otherwise complying with the provisions of this Act, the protected cell company will receive statutory insulation of those assets and liabilities from the protected cell company’s other assets and liabilities not identified in the accounting records as attributable to the protected cell.

H. “Protected cell account” means a specifically identified bank or custodial account established by a protected cell company for the purpose of segregating the protected cell assets of one protected cell from the protected cell assets of other protected cells and from the assets of the protected cell company’s general account.

Drafting Note: This term is meant to reference a custodial account established to hold and invest protected cell assets, such that protected cell assets are also distinct and identifiable from the assets of the general account.

I. “Protected cell assets” means all assets, contract rights and general intangibles, identified with and attributable to a specific protected cell of a protected cell company.

J. “Protected cell company” means a domestic insurer that has one or more protected cells.

K. “Protected cell company insurance securitization” means the issuance of debt instruments, the proceeds from which support the exposures attributed to the protected cell, by a protected cell company where repayment of principal or interest, or both, to investors pursuant to the transaction terms is contingent upon the occurrence or nonoccurrence of an event with respect to which the protected
cell company is exposed to loss under insurance or reinsurance contracts it has issued.

L. "Protected cell liabilities" means all liabilities and other obligations identified with and attributable to a specific protected cell of a protected cell company.

Section 4. Establishment of Protected Cells

A. A protected cell company may establish one or more protected cells with the prior written approval of the commissioner of a plan of operation or amendments thereto submitted by the protected cell company with respect to each protected cell in connection with an insurance securitization. Upon the written approval of the commissioner of the plan of operation, which shall include, but not be limited to, the specific business objectives and investment guidelines of the protected cell, the protected cell company may, in accordance with the approved plan of operation, attribute to the protected cell insurance obligations with respect to its insurance business and obligations relating to the insurance securitization and assets to fund the obligations. A protected cell shall have its own distinct name or designation, which shall include the words "protected cell." The protected cell company shall transfer all assets attributable to a protected cell to one or more separately established and identified protected cell accounts bearing the name or designation of that protected cell. Protected cell assets shall be held in the protected cell accounts for the purpose of satisfying the obligations of that protected cell.

Drafting Note: Insert the title of the chief insurance regulatory official wherever the term "commissioner" appears.

B. All attributions of assets and liabilities between a protected cell and the general account shall be in accordance with the plan of operation approved by the commissioner. No other attribution of assets or liabilities may be made by a protected cell company between the protected cell company’s general account and its protected cells. Any attribution of assets and liabilities between the general account and a protected cell, or from investors in the form of principal on a debt instrument issued by a protected cell company in connection with a protected cell company securitization shall be in cash or in readily marketable securities with established market values.

C. The creation of a protected cell does not create, in respect of that protected cell, a legal person separate from the protected cell company. Amounts attributed to a protected cell under this Act, including assets transferred to a protected cell account, are owned by the protected cell company and the protected cell company may not be, nor hold itself out to be, a trustee with respect to those protected cell assets of that protected cell account. Notwithstanding the foregoing, the protected cell company may allow for a security interest to attach to protected cell assets or a protected cell account when in favor of a creditor of the protected cell and otherwise allowed under applicable law.

D. This Act shall not be construed to prohibit the protected cell company from contracting with or arranging for an investment advisor, commodity trading advisor, or other third party to manage the protected cell assets of a protected cell, provided that all remuneration, expenses and other compensation of the third party advisor or manager are payable from the protected cell assets of that protected cell and not from the protected cell assets of other protected cells or the assets of the protected cell company’s general account.
E.  (1) A protected cell company shall establish administrative and accounting procedures necessary to properly identify the one or more protected cells of the protected cell company and the protected cell assets and protected cell liabilities attributable to the protected cells. It shall be the duty of the directors of a protected cell company to:

(a) Keep protected cell assets and protected cell liabilities separate and separately identifiable from the assets and liabilities of the protected cell company’s general account and;

(b) Keep protected cell assets and protected cell liabilities attributable to one protected cell separate and separately identifiable from protected cell assets and protected cell liabilities attributable to other protected cells.

(2) Notwithstanding the foregoing, if this section is violated, the remedy of tracing shall be applicable to protected cell assets when commingled with protected cell assets of other protected cells or the assets of the protected cell company’s general account. The remedy of tracing shall not be construed as an exclusive remedy.

F. The protected cell company shall, when establishing a protected cell, attribute to the protected cell assets with a value at least equal to the reserves and other insurance liabilities attributed to that protected cell.

Section 5. Use and Operation of Protected Cells

A. The protected cell assets of a protected cell may not be charged with liabilities arising out of any other business the protected cell company may conduct. All contracts or other documentation reflecting protected cell liabilities shall clearly indicate that only the protected cell assets are available for the satisfaction of those protected cell liabilities.

B. The income, gains and losses, realized or unrealized, from protected cell assets and protected cell liabilities shall be credited to or charged against the protected cell without regard to other income, gains or losses of the protected cell company, including income, gains or losses of other protected cells. Amounts attributed to any protected cell and accumulations on the attributed amounts may be invested and reinvested without regard to any requirements or limitations of Section [insert reference applicable sections of the insurance code imposing limitations on insurance company investments] and the investments in a protected cell or cells shall not be taken into account in applying the investment limitations otherwise applicable to the investments of the protected cell company.

C. Assets attributed to a protected cell shall be valued at their fair value on the date of valuation.

D. A protected cell company shall, in respect of any of its protected cells, engage in fully funded indemnity triggered insurance securitization to support in full the protected cell exposures attributable to that protected cell. A protected cell company insurance securitization that is non-indemnity triggered shall qualify as an insurance securitization under the terms of this Act only after the commissioner, in accordance with the authority granted under Section 9 of this Act, adopts regulations addressing the methods of funding of the portion of the risk that is not indemnity based, accounting, disclosure, risk based capital treatment, and assessing risks associated with such securitizations. A protected cell company insurance securitization that is not fully funded, whether indemnity
triggered or non-indemnity triggered, is prohibited. Protected cell assets may be used to pay interest or other consideration on any outstanding debt or other obligation attributable to that protected cell, and nothing in this subsection shall be construed or interpreted to prevent a protected cell company from entering into a swap agreement or other transaction for the account of the protected cell that has the effect of guaranteeing interest or other consideration.

E. In all protected cell company insurance securitizations, the contracts or other documentation effecting the transaction shall contain provisions identifying the protected cell to which the transaction will be attributed. In addition, the contracts or other documentation shall clearly disclose that the assets of that protected cell, and only those assets, are available to pay the obligations of that protected cell. Notwithstanding the foregoing, and subject to the provisions of this Act and any other applicable law or regulation, the failure to include such language in the contracts or other documentation shall not be used as the sole basis by creditors, reinsurers or other claimants to circumvent the provisions of this Act.

F. A protected cell company shall only be authorized to attribute to a protected cell account the insurance obligations relating to the protected cell company's general account. Under no circumstances shall a protected cell be authorized to issue insurance or reinsurance contracts directly to policyholders or reinsureds or have any obligation to the policyholders or reinsureds of the protected cell company's general account.

G. At the cessation of business of a protected cell in accordance with the plan approved by the commissioner, the protected cell company shall voluntarily close out the protected cell account.

Section 6. Reach of Creditors and Other Claimants

A. (1) Protected cell assets shall only be available to the creditors of the protected cell company that are creditors in respect to that protected cell and shall thereby be entitled, in conformity with the provisions of this Act, to have recourse to the protected cell assets attributable to that protected cell, and shall be absolutely protected from the creditors of the protected cell company that are not creditors in respect of that protected cell and who, accordingly, shall not be entitled to have recourse to the protected cell assets attributable to that protected cell. Creditors with respect to a protected cell shall not be entitled to have recourse against the protected cell assets of other protected cells or the assets of the protected cell company's general account.

(2) Protected cell assets shall only be available to creditors of a protected cell company after all protected cell liabilities have been extinguished or otherwise provided for in accordance with the plan of operation relating to that protected cell.

B. When an obligation of a protected cell company to a person arises from a transaction, or is otherwise imposed, in respect of a protected cell:

(1) That obligation of the protected cell company shall extend only to the protected cell assets attributable to that protected cell, and the person shall, with respect to that obligation, be entitled to have recourse only to the protected cell assets attributable to that protected cell; and

(2) That obligation of the protected cell company shall not extend to the protected cell assets of any other protected cell or the assets of the
protected cell company’s general account, and that person shall not, with respect to that obligation, be entitled to have recourse to the protected cell assets of any other protected cell or the assets of the protected cell company’s general account.

C. When an obligation of a protected cell company relates solely to the general account, the obligation of the protected cell company shall extend only to, and that creditor shall, with respect to that obligation, be entitled to have recourse only to, the assets of the protected cell company’s general account.

D. The activities, assets, and obligations relating to a protected cell are not subject to the provisions of Section [insert applicable sections of the insurance code addressing life and health and property and casualty guaranty or insolvency funds], and neither a protected cell nor a protected cell company shall be assessed by or otherwise be required to contribute to any guaranty fund or guaranty association in this state with respect to the activities, assets, or obligations of a protected cell. Nothing in this subsection shall affect the activities or obligations of an insurer’s general account.

E. In no event shall the establishment of one or more protected cells alone constitute or be deemed to be a fraudulent conveyance, an intent by the protected cell company to defraud creditors, or the carrying out of business by the protected cell company for any other fraudulent purpose.

Section 7. Conservation, Rehabilitation or Liquidation of Protected Cell Companies

A. Notwithstanding any contrary provision in the insurance code of this state, the regulations promulgated under the insurance code of this state, or any other applicable law or regulation, upon any order of conservation, rehabilitation or liquidation of a protected cell company, the receiver shall be bound to deal with the protected cell company’s assets and liabilities, including protected cell assets and protected cell liabilities, in accordance with the requirements set forth in this Act.

B. With respect to amounts recoverable under a protected cell company insurance securitization, the amount recoverable by the receiver shall not be reduced or diminished as a result of the entry of an order of conservation, rehabilitation or liquidation with respect to the protected cell company notwithstanding any provisions to the contrary in the contracts or other documentation governing the protected cell company insurance securitization.

Drafting note: A number of states require a liquidator to cancel policies within a pre-specified time period in the event of a liquidation. While reviewing the Plan of Operation, commissioners should consider the termination provisions, if any, of the securitization instruments in the event of the cancellation of all of the insurance policies underlying the securitization in order to assess whether any portion of the risk premium relating to those underlying policies should equitably be returned to the estate of the general account.
Section 8. No Transaction of an Insurance Business

A protected cell company insurance securitization shall not be deemed to be an insurance or reinsurance contract. An investor in a protected cell company insurance securitization shall not, by sole means of this investment, be deemed to be transacting an insurance business in this state. The underwriters or selling agents (and their partners, directors, officers, members, managers, employees, agents, representatives and advisors) involved in a protected cell company insurance securitization shall not be deemed to be conducting an insurance or reinsurance agency, brokerage, intermediary, advisory or consulting business by virtue of their activities in connection therewith.

Section 9. Authority to Adopt Regulations

The commissioner may promulgate regulations necessary to effectuate the purposes of this Act.

Section 10. Effective Date

This Act shall become effective on [insert date].

RELEVANT LITERATURE

Statutory Accounting
- Emerging Accounting Issues Working Group Minutes 99-3

Generally Accepted Accounting Principles
- FAS 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
- FAS 133, Accounting for Derivative Instruments and Hedging Activities

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

Other Sources
- Protected Cell Model Act
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Statutory Issue Paper No. 104

Reinsurance Deposit Accounting - An Amendment to SSAP No. 62—Property and Casualty Reinsurance

STATUS
Finalized September 12, 2000

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principle No. 62—Property and Casualty Reinsurance (SSAP No. 62) prescribes the accounting treatment for reinsurance contracts that do not transfer both components of insurance risk (underwriting risk and timing risk). The requirements for Generally Accepted Accounting Principles (GAAP) are contained within American Institute of Certified Public Accountants (AICPA) Statement of Position No. 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That do not Transfer Insurance Risk (SOP No. 98-7).

2. The purpose of this issue paper is to address the requirements of SOP 98-7 and amend the deposit accounting provisions of SSAP No. 62. In considering GAAP guidance as reflected in SOP 98-7, the purpose of this issue paper is to amend the deposit accounting provisions of SSAP No. 62 and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Deposit Accounting

3. This issue paper supersedes paragraph 34 of SSAP No. 62. The following guidance shall be followed when reinsurance contracts do not transfer both components of insurance risk.

4. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

   a. At the outset of the reinsurance agreement, the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding company and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding company if (i) the assuming company is licensed, accredited or otherwise qualified in the ceding company’s state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding company which meet the requirements of paragraph 16 of Appendix A-785;

   b. At subsequent reporting dates, the amount of the deposit/liability should be adjusted by calculating the effective yield on the deposit agreement to reflect actual payments to date (receipts and disbursements should be recorded through the deposit/liability accounts) and expected future payments (as discussed below), with a corresponding credit or charge to interest income or interest expense;

   c. The calculation of the effective yield should use the estimated amount and timing of cash flows. If a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows.
The deposit should be adjusted to the amount that would have existed at the reporting date had the new effective yield been applied since the inception of the reinsurance agreement. Changes in the carrying amount of the deposit asset/liability resulting from changes in the effective yield shall be recorded as interest income or interest expense.

d. It shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the deposit liability shall be recorded as interest expense – by the assuming insurer. Conversely, the ceding insurer shall increase its deposit (asset) with an offsetting credit to interest income; and increase its outstanding loss liability with an offsetting charge to incurred losses;

e. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company’s Statement of Financial Position, schedules, and exhibits;

f. The assuming company shall record net consideration to be returned to the ceding company as a liability.

(For an illustration of the provisions of paragraph 4 see Exhibit A)

Disclosures

5. The financial statements shall disclose the following with respect to reinsurance agreements that have been accounted for as deposits:

a. A description of the reinsurance agreements.

b. Any adjustment of the amounts initially recognized for expected recoveries. The individual components of the adjustment (e.g., interest accrual, change due to a change in estimated or actual cash flow) shall be disclosed separately.

DISCUSSION

6. Subsequent to the adoption of SSAP No. 62, the AICPA issued SOP 98-7. This SOP provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-term life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in this SOP as deposit accounting. The SOP does not address when deposit accounting should be applied.

7. This issue paper adopts, with modification, AICPA SOP 98-7 paragraphs 10 to 12 and 19 (subsection b only). The fundamental concepts of SSAP No. 62 are based upon the fact that unless a reinsurance contract contains a transfer of insurance risk, no underwriting credit shall be granted. The critical ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). SOP 98-7 paragraphs 10 to 12 requires the use of the interest method for contracts that transfer neither timing nor underwriting risk and contracts that only transfer timing risk. This issue paper adopts the interest method contained with those paragraphs, but modifies the SOP to require the interest method when the contract does not transfer one or both components of insurance risk.

8. The issue paper rejects AICPA SOP 98-7 paragraphs 13 to 17 and 19 (subsections a and c). This is due to the fact that the SOP allows entities to take underwriting credit for contracts that only transfer
significant underwriting risk. This is in direct conflict with the fundamental concept that reinsurance contracts must transfer insurance risk (both underwriting and timing risks).

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
9. SSAP No. 62 paragraph 34:

Deposit Accounting
34. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding entity and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding entity if (i) the assuming entity is licensed, accredited or otherwise qualified in the ceding entity’s state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding entity as described in Appendix A-785;

b. Throughout the life of the agreement, receipts and disbursements shall be recorded through the deposit/liability accounts;

c. When individual case reserves are the basis for the deposit and the assuming entity pays in excess of the amount transferred by the ceding entity, the amount paid in excess of the deposit received shall be recognized as a loss by the assuming entity and as a gain by the ceding entity as Other Income in the statement of income;

d. When the agreement is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded in the Other Income or Loss account as a loss to the reinsurer and as a gain in the Other Income or Loss account by the reinsured;

e. With regard to bulk reserves, (i.e., IBNR) it shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the liability shall be recorded as a loss recognized by the assuming entity. Conversely, the ceding entity shall increase its deposit (asset) and outstanding loss liability;

f. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding entity’s balance sheet, schedules, and exhibits; and

g. The assuming entity shall record net consideration to be returned to the ceding entity as liabilities.

10. The Property Casualty Reinsurance Study Group of the Accounting Practices and Procedures (E) Task Force reviewed SOP 98-7 in detail. The Study Group adopted its position at its March 7, 1999 meeting. The conclusion of this issue paper is consistent with the Study Group’s recommendation. The applicable section of the minutes is included herein:

Michael Moriarty (N.Y.) opened the meeting by inviting Keith Bell (Travelers) to comment on his previously submitted proposal to revise statutory accounting guidance to permit accrual of interest income or expense related to funds held on deposit type transactions. Mr. Bell stated that the intent of the proposed revision was to make the statutory rules more consistent with
Generally Accepted Accounting Procedures (GAAP) treatment, by using the interest method to reflect the actual cash flows and to periodically adjust the implicit rate of interest.

Peter Medley (Wis.) raised a question regarding the interest rate to be used for this purpose. Frank Maffa (American Reinsurance Company) explained that reinsurance agreements which did not satisfy risk transfer requirements had to be accounted for as deposit-transactions, and suggested that it would be appropriate to recognize the interest income or expense associated with the funds on deposit in a timely manner over the life of the transaction. Mr. Moriarty commented that he saw no reason not to permit accrual of such amounts and asked Norris Clark (Calif.) to explain how the proposed revision would be implemented. Mr. Clark said that the proposal would go from the study group to the Accounting Practices and Procedures Task Force, which would presumably consider the proposal to be a codification maintenance item which need not be referred to the Emerging Accounting Issues Task Force before the proposal could be implemented as a revision to the pertinent language in Statement of Statutory Accounting Principles (SSAP) No. 62 and the corresponding section of the Accounting Practices and Procedures Manual for Property and Casualty Companies.

Thomas Burke (N.H.) moved to adopt the proposal and Mr. Clark seconded the motion which passed on a 4 to 1 vote of the study group members.

Generally Accepted Accounting Principles

11. AICPA SOP 98-7 paragraphs 9 to 20:

Initial Measurement

9. At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit assets and liabilities should be reported on a gross basis, unless the right of offset exists as defined in FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts. The accounting by the insured and insurer are symmetrical, except as noted in paragraph 15 of this SOP.

Subsequent Measurement

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Underwriting Risk

10. For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability should be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph 11 below), with a corresponding credit or charge to interest income or expense. This approach is consistent with the interest method described in Accounting Principles Board (APB) Opinion No. 21, Interest on Receivables and Payables, and FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.

11. The calculation of the effective yield should use the estimated amount and timing of cash flows. Consistent with paragraph 19 of FASB Statement No. 91, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since the inception of the insurance or reinsurance contract. Changes in the carrying amount of the deposit should be reported as interest income or interest expense.
12. Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the enterprise should determine whether the change indicates that the contract does include significant underwriting risk and therefore should be converted to the accounting for contracts that transfer only significant underwriting risk. (See paragraphs 13 through 15 for the accounting guidance for insurance and reinsurance contracts that transfer only significant underwriting risk.) In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

13. Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting risk, the deposit should be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

14. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or reinsurance contract that transfers only significant underwriting risk should be recorded in an insured’s income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer’s income statement as an incurred loss. Insurance enterprises should record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses. Insurance enterprises should disclose the amounts related to those deposit contracts that are reported in incurred losses in their statement of earnings. (See paragraph 19.) If the insured is an enterprise other than an insurance enterprise, the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

15. For the insured or ceding enterprise, the discount rate used to determine the deposit asset should be the current rate on United States government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, should be based on the assessment of the creditworthiness of the insurer. For the insurer or assuming enterprise, the discount rate used to determine the deposit liability should be the current rate on United States government obligations with similar cash-flow characteristics. These rates should be established at the date of each loss incurred and used for the remaining life of the contract and should not be changed. If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed recordkeeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

Insurance and Reinsurance Contracts With Indeterminate Risk

16. Uncertainties surrounding insurance and reinsurance contracts with indeterminate risk are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5, Accounting for Foreign Property and Liability Reinsurance. As a result, the guidance in SOP 92-5, regarding the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to FASB Statement No. 5.

17. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified
into one of the three categories as an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. The change in deposit assets or liabilities that result if sufficient information becomes available is treated as a change in accounting estimate in accordance with APB Opinion 20, Accounting Changes.

Disclosures

18. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

19. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

   a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred loses

   b. Any adjustment of amounts initially recognized for expected recoveries (The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.)

   c. The amortization expense attributable to the expiration of coverage provided under the contract

20. This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Previously issued annual financial statements should not be restated. The initial application of this SOP should be as of the beginning of an entity’s fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

RELEVANT LITERATURE

Statutory Accounting
- SSAP No. 62—Property and Casualty Reinsurance
- March 7, 1999 minutes of the P/C Reinsurance Study Group

Generally Accepted Accounting Principles
- American Institute of Certified Public Accountants (AICPA) Statement of Position No. 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That do not Transfer Insurance Risk

State Regulations
- No additional guidance obtained from state statutes or regulations.
Exhibit A  
Illustration of a Reinsurance Contract That Is Accounted for as a Deposit using the Interest Method

Assumptions:
- Premium = $1,000 (assumes no commissions or allowances)
- Coverage Period = 1 year
- Initial expected recoveries = $225 per year (at end of year) for five years
- Initial Implicit rate = 4 percent*

*present value of $225 per year for five years at 4 percent = $1,000

At the end of Year 2, the timing of anticipated recoveries under the reinsurance contract changes. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year.

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</tr>
<tr>
<td>Year 6 (3.63 %)</td>
<td>$ 7</td>
<td>$(175)</td>
<td>$ 175</td>
</tr>
<tr>
<td>End of Year 6</td>
<td></td>
<td></td>
<td>$ 0</td>
</tr>
</tbody>
</table>

At the inception of the contract, the ceding insurer records a deposit asset of $1,000 and the assuming company, a $1,000 deposit liability. The asset is admitted providing the conditions for credit for reinsurance are met.

At subsequent reporting dates, the deposit asset is adjusted by calculating the effective yield on the reinsurance agreement to reflect actual payments to date and expected future payments with a corresponding credit to interest income by the ceding company and interest expense by the assuming company.

At the end of year two, it is determined that the expected cash flows will differ from previous estimates, resulting in a lower effective yield on the deposit asset. The deposit asset is adjusted to the amount that would have existed at the reporting date had the new effective yield been applied from the inception of the reinsurance agreement. The adjustment is charged to interest income, i.e., as a reduction of interest income. Interest income during the remaining term of the agreement is reduced accordingly (i.e., the yield is reduced from 4.0% to 3.63%).
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Statutory Issue Paper No. 105

Reporting on the Costs of Start-Up Activities

STATUS
Finalized September 12, 2000

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper addresses start-up costs. In practice, various terms are used to refer to start-up costs, such as preopening, preoperating, and organization costs. For purpose of this issue paper, these costs are referred to as start-up costs. Current statutory accounting guidance is provided in SSAP No. 17—Preoperating and Research and Development Costs (SSAP No. 17). American Institute of Certified Public Accountants (AICPA) Statement of Position 98-5, Reporting on the Costs of Start-Up Activities, (SOP 98-5) specifically addresses the reporting of start-up costs.

2. The purpose of this issue paper is to adopt SOP 98-5 with modification to add certain disclosure requirements, which is consistent with SSAP No. 17 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Cost of start-up activities, including organization costs, shall be expensed as incurred. Start-up activities are defined broadly as those one-time activities related to: (1) opening a new facility; (2) introducing a new product or service; (3) conducting business in a new territory; (4) conducting business with a new class of customer or beneficiary; (5) initiating a new process in an existing facility; or (6) commencing some new operation. Start-up activities include activities related to organizing a new entity (commonly referred to as organization costs).

4. Cost of start-up activities incurred in an accounting period shall be disclosed in the annual audited statutory financial report only.

DISCUSSION

5. This issue paper adopts SOP 98-5, which requires costs of start-up activities and organization costs to be expensed as incurred. This is consistent with SSAP No. 17 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy.

6. SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) defines an asset as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Although in some instances start-up and organization costs may appear to comply with the definition of an asset established by SSAP No. 4, it is not consistent with the “Conservatism” concept included in the Statement of Concepts to presume that it is “probable” that an entity in a start-up phase will generate future economic benefits. Start-up and organization costs, therefore, do not meet the definition of an asset for statutory accounting purposes and as such should be expensed as incurred. To expense rather than to capitalize such costs is also consistent with the Recognition concept included in the Statement of Concepts, which states that a reporting entity’s “ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.”
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
7. SSAP No. 17, paragraph 2 states:

Preoperating, including organization and start up costs, and research and development costs shall be expensed as incurred. Preoperating and research and development costs are incurred for such new projects as: (a) arranging operations for a new company (e.g., legal, actuarial and accounting costs associated with regulatory approval and licensing and issuance of stock); (b) establishing production, sales or service facilities at a new site; (c) changing operations or production significantly; or (d) developing and producing a new product, adopting a new process or offering a new service.

Generally Accepted Accounting Principles
8. SOP 98-5, paragraph 12 states:

Conclusions

Accounting for Start-Up Costs

.12 Costs of start-up activities, including organization costs, should be expensed as incurred.

Drafting Notes/Comments
- SOP 98-5 contains illustrations that provide examples. These illustrations should not be interpreted to be all-inclusive.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 17—Preoperating and Research and Development Costs
- SSAP No. 4—Assets and Nonadmitted Assets

Generally Accepted Accounting Principles
- AICPA Statement of Position 98-5, Reporting on the Costs of Start-Up Activities

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 106

Real Estate Sales – An Amendment to SSAP No. 40—Real Estate Investments

STATUS
Finalized September 12, 2000

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for Real Estate is provided in SSAP No. 40—Real Estate Investments (SSAP No. 40). SSAP No. 40 adopted FASB Statement No. 66, Accounting for Sales of Real Estate (FAS 66), with modification to paragraph 9 to indicate that only letters of credit from institutions listed by the Securities Valuation Office shall be included in determining the buyer’s initial investment. Although FAS 66 states that it is applicable to all sales of real estate, it does not explicitly define real estate or identify the real estate transactions to which it is specifically applicable.

2. Paragraph 1 of FASB Statement No. 66, Accounting for Sales of Real Estate, states, “This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller’s business.” FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66 (FIN 43) clarifies that the phrase “all real estate sales” to include sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. FASB Emerging Issues Task Force 00-13, Determining Whether Equipment is “Integral Equipment” Subject to FASB Statements No. 66 and No. 98 (EITF 00-13) adds guidance relative to the definition of integral equipment.

3. The purpose of this issue paper is to adopt FIN 43 and EITF 00-13 which is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper supersedes paragraphs 16 and 17 of SSAP No. 40. The following guidance shall be followed when accounting for the sales of real estate.

5. Recognition of profit on sales of real estate investments shall be accounted for in accordance with FASB Statement No. 66, Accounting for Sales of Real Estate (FAS 66), except as modified in paragraph 6 of this statement, FASB Emerging Issues Task Force No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds (EITF 87-9), FASB Emerging Issues Task Force No. 87-29, Exchange of Real Estate Involving Boot (EITF 87-29), FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66 (FIN 43) and FASB Emerging Issues Task Force 00-13, Determining Whether Equipment is “Integral Equipment” Subject to FASB Statements No. 66 and No. 98. This issue paper applies to all sales of real estate including real estate with property improvements or integral equipment. The terms “property improvements” and “integral equipment” refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant costs, such as an office building. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:
a. A sale is consummated;

b. The buyer’s initial and continuing investments are adequate to demonstrate a commitment to pay for the property;

c. The seller’s receivable is not subject to future subordination; and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

6. The calculation of the buyer’s initial investment specified in paragraph 9 of FAS 66 shall be modified to reflect that buyer’s notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer’s initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

DISCUSSION

7. This issue paper adopts FIN 43, which clarifies that the phrase “all real estate sales” includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. This is consistent with SSAP No. 40 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. This issue paper also adopts EITF 00-13 which clarifies use of the term “integral equipment”.

Drafting Notes/Comments
- Accounting for leases and sale-leaseback transactions involving real estate transactions are addressed in SSAP No. 22—Leases.
- Accounting for leasehold improvements is addressed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements.
- Accounting for transfers and servicing of financial assets and extinguishments of liabilities is addressed in SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. SSAP No. 40, paragraphs 16 and 17 state:

Sale of Real Estate
16. Recognition of profit on sales of real estate investments shall be accounted for in accordance with FASB Statement No. 66, Accounting for Sales of Real Estate (FAS 66), except as modified in paragraph 17 of this statement, FASB Emerging Issues Task Force No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds (EITF 87-9), and FASB Emerging Issues Task Force No. 87-29, Exchange of Real Estate Involving Boot (EITF 87-29). Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:

a. A sale is consummated;
b. The buyer’s initial and continuing investments are adequate to demonstrate a commitment to pay for the property;

c. The seller’s receivable is not subject to future subordination; and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

17. The calculation of the buyer’s initial investment specified in paragraph 9 of FAS 66 shall be modified to reflect that buyer’s notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer’s initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

Generally Accepted Accounting Principles

9. FIN 43 provides the following guidance:

INTERPRETATION

2. Statement 66 applies to all sales of real estate, including real estate with property improvements or integral equipment. The terms property improvements and integral equipment as they are used in this Interpretation refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery.

3. The provisions of Statement 66 do not apply to transactions that involve the following:

a. The sale of only property improvements or integral equipment without a concurrent (or contemplated) sale of the underlying land\(^1\)

\(^1\) Except for sales of property improvements or integral equipment with the concurrent lease (whether explicit or implicit in the transaction) of the underlying land to the buyer. Those transactions should be accounted for in accordance with paragraphs 38 and 39 of Statement 66. In addition, sales of property improvements or integral equipment subject to an existing lease of the underlying land are also subject to the provisions of Statement 66.

b. The sale of the stock or net assets of a subsidiary or a segment of a business if the assets of that subsidiary or that segment, as applicable, contain real estate, unless the transaction is, in substance, the sale of real estate

c. The sale of securities that are accounted for in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.\(^2\)

\(^2\) Sales of those types of securities are addressed by FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

4. In the first sentence of paragraph 38 of Statement 66, the phrase property improvements is interpreted to include both property improvements and integral improvements (to conform that paragraph to the scope clarification provided by this Interpretation).
10. EITF 00-13 provides the following guidance:

1. With the issuance of Interpretation 43, which concludes that sales of integral equipment are within the scope of Statement 66, determining whether equipment constitutes "integral equipment" has taken on increased importance as that determination now affects whether the detailed guidance in Statement 66 should be applied to a transfer of equipment. Further, the appropriateness of sales-type lease classification by lessors for leases involving equipment is also impacted by the determination of whether the equipment to be leased is "integral equipment." In addition, that determination is important for reaching a conclusion as to whether Statement 98, with its more stringent provisions, applies to a sale-leaseback transaction.

2. Integral equipment is defined in Interpretation 43 as "any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost." The authoritative pronouncements governing the accounting for leasing transactions and sales of real estate do not provide any guidance for interpreting the phrase "cannot be removed and used separately without incurring significant cost," and, as a result, there may be diversity in practice with respect to determining what constitutes "integral equipment" for the purpose of applying Statements 13, 66, and 98.

3. This issue is how the determination of whether equipment is integral equipment should be made.

EITF 00-13 DISCUSSION

4. The Task Force agreed that the phrase "cannot be removed and used separately without incurring significant cost" contains two distinct concepts: (a) the ability to remove the equipment without incurring significant cost and (b) the ability of a different entity to use the equipment at another location without significant diminution in utility or value. The Task Force reached a consensus that the determination of whether equipment is integral equipment should be based on the significance of the cost to remove the equipment from its existing location (which would include the cost of repairing damage done to the existing location as a result of the removal), combined with the decrease in the value of the equipment as a result of that removal. The Task Force agreed that, at a minimum, the decrease in the value of the equipment as a result of its removal is the estimated cost to ship and reinstall the equipment at a new site. The nature of the equipment, and the likely use of the equipment by other potential users, should be considered in determining whether any additional diminution in fair value exists beyond that associated with costs to ship and install the equipment.

5. When the combined total of both the cost to remove plus the decrease in value (for leasing transactions, the information used to estimate those costs and the decrease in value should be as of lease inception) exceeds 10 percent of the fair value of the equipment (installed) (for leasing transactions, at lease inception), the equipment is integral equipment.

6. Refer to Exhibit 00-13A for an example that illustrates the application of this consensus.

Exhibit 00-13A

ILLUSTRATION OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 00-13

Company A leases equipment to Company B for use in a manufacturing facility. The fair value of the production equipment (installed) at lease inception is $1,075,000. The estimated cost to remove the equipment after installation (estimate is as of the beginning of the lease term) is $80,000, which includes $30,000 to repair damage to the existing location as a result of the removal. The estimated cost to ship and reinstall the equipment at a new site (estimated as of the beginning of the lease term) is $85,000. For this example, assume that the equipment would have the same fair value (installed) to the seller and a potential buyer. Therefore, there is no
diminution in fair value of the equipment beyond the discount a purchaser would presumably require to cover the cost to ship and reinstall the equipment.

In accordance with this consensus, Company A would assess whether or not the production equipment is integral equipment as follows $(80,000 + 85,000) ÷ 1,075,000 = 15.3\%$ percent. Because the cost of removal combined with the diminution in value exceeds 10 percent of the fair value (installed) of the production equipment, the cost to remove the equipment and use it separately is deemed to be significant. Therefore, the production equipment is integral equipment.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 40—Real Estate Investments

Generally Accepted Accounting Principles
- FASB Interpretation No. 43, Real Estate Sales, an interpretation of FASB Statement No. 66
- FASB Statement No. 66, Accounting for Sales of Real Estate
- FASB Emerging Issues Task Force 00-13, Determining Whether Equipment is “Integral Equipment” Subject to FASB Statements No. 66 and No. 98

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 107

Certain Health Care Receivables and Receivables Under Government Insured Plans

STATUS
Finalized August 8, 2001

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. **SSAP No. 4—Assets and Nonadmitted Assets** (SSAP No. 4) provides the definition of admitted and nonadmitted assets.

2. Pharmaceutical rebates are arrangements between pharmaceutical companies and reporting entities in which the reporting entities receive rebates based upon the drug utilization of its subscribers at participating pharmacies. Reporting entities use different ways to record pharmacy rebates on their financial statements. These rebates are sometimes recorded as receivables by reporting entities using estimates based upon historical trends which should be adjusted to reflect significant variables involved in the calculation, such as number of prescriptions written/filled, type of drugs prescribed, use of generic vs. brand-name drugs, etc. In some cases, the reporting entity determines the amount of the rebate due based on the actual use of various prescription drugs during the accumulation period and then invoices the pharmaceutical company. In other cases, an affiliated or unaffiliated pharmacy benefits management company may determine the amount of the rebate based on a listing (of prescription drugs filled) prepared for the reporting entity’s review. The reporting entity will confirm the listing and the pharmaceutical rebate receivable. The pharmacy benefits management company will then collect the amount due from the pharmaceutical company for remittance to the reporting entity. Some reporting entities do not participate in rebate arrangements at all but receive similar benefits through contracted discounts on pharmaceutical purchases. Current statutory accounting guidance does not specifically address the admittance of pharmaceutical rebates.

3. Claim overpayments may occur as a result of several events, including but not limited to claim payments made in error to a provider. Reporting entities often establish receivables for claim overpayments. Claim overpayments may meet the conditions for the right of offset as defined in **SSAP No. 64—Offsetting and Netting of Assets and Liabilities** (SSAP No. 64). Since claim overpayments are not specifically identified as an admitted asset within the Accounting Practices and Procedures Manual effective January 1, 2001 they would be reported as nonadmitted.

4. A health entity may make loans or advances to large hospitals or other providers. Such loans or advances are supported by legally enforceable contracts and are generally entered into at the request of the provider. In many cases, loans or advances are paid monthly and are intended to represent one month of fee-for-service claims activity with the respective provider. At least for large hospitals with many sources of cash flow, an offset for these loans and advances exists in the reporting entity’s combined reported and unreported claims liability and claims reserve. Additionally, such loans and advances are generally reconciled quarterly against actual claim utilization (allowing for adequate run-out of such claims) pursuant to contractual terms. In such cases, the reconciled differences are settled and the advance payments for future months may be adjusted based upon the materiality of reconciled differences. Current statutory guidance in **SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties** (SSAP No. 25) is limited to loans and advances to related parties.
5. The glossary to the statements of statutory accounting principles contained in the Accounting Practices and Procedures Manual effective January 1, 2001, defines a capitation arrangement as a compensation plan used in connection with some managed care contracts in which a physician or other medical provider is paid a flat amount, usually on a monthly basis, for each subscriber who has elected to use that physician or medical provider. Risk sharing agreements are contracts between reporting entities and providers with a risk sharing element based upon utilization. The compensation payments for risk sharing agreements are typically estimated monthly and settled annually. These agreements can result in receivables due from the providers if annual utilization is different than that used in estimating the monthly compensation. SSAP No. 25 provides accounting guidance for loans and advances and advances under capitation arrangements to providers who meet the definition of related parties.

6. Current GAAP provides guidance relative to defining a health care receivable and accounting guidance on loan impairment. Such guidance is presented in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide: Health Care Organizations. This audit guide was rejected in SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities.

7. SSAP No. 47—Uninsured Plans (SSAP No. 47) paragraph 10 c. provides accounting guidance for the admissibility of uninsured Medicare and similar government funded plans. Current statutory accounting guidance does not specifically address the admittance of amounts receivable under government insured plans.

8. The purpose of this issue paper is to establish statutory accounting principles for pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers who do not meet the definition of related parties, capitation arrangement receivables, risk sharing receivables, and amounts receivable under government insured plans consistent with the Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

9. The definition and accounting treatment for nonadmitted assets is outlined in paragraph 3 of SSAP No. 4 as follows:

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

a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity’s capitalization policy, immaterial amounts of furniture, fixtures, equipment, or supplies, can be expensed when purchased.
10. Pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers, capitation arrangement receivables, risk sharing receivables, and amounts receivable under government insured plans meet the definition of assets as set forth in SSAP No. 4, and are admitted assets to the extent that the requirements for admission defined in this issue paper are met.

11. This issue paper shall not be considered an all-inclusive list of health care receivables. Certain health care receivables are addressed in other statements. Health care receivable assets not addressed in other statements or this statement are nonadmitted assets.

**Pharmaceutical Rebate Receivables**

12. Pharmaceutical rebates receivables consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below:

   a. Estimated amounts shall be related solely to actual prescriptions filled during the 3 months immediately preceding the reporting date;

   b. Billed amounts represent pharmaceutical rebate receivables that have been invoiced or confirmed in writing but not collected as of the reporting date. Billed amounts for an estimated amount under paragraph 12 a. above shall be admitted only if the determination of the rebate, based on actual prescriptions filled, occurs and is invoiced or confirmed in writing within the 2 months following the reporting date of the estimated amount. Adjustments to previously billed amounts related to prior periods shall be nonadmitted until invoiced or confirmed in writing. Pharmaceutical rebates that have not been collected within 90 days of the invoice date or confirmation date shall be nonadmitted. Furthermore, if accrued pharmaceutical rebate receivables are not invoiced or confirmed in writing in accordance with the contract provisions, the accrual shall be nonadmitted; and

   c. Evaluation of the collectibility of pharmaceutical rebate receivables shall be made periodically. If in accordance with *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

13. The method used to reasonably estimate the receivable shall be consistent from period to period and shall be adjusted periodically for any changes in the underlying pharmaceutical rebate contract provisions. The financial statements shall disclose information regarding the reporting entity’s pharmaceutical rebates in accordance with paragraph 26 of this issue paper.

14. Income from pharmaceutical rebates of insured plans shall be reported as a reduction to claims expense on the summary of operations.

15. Receivable and payable balances related to uncollected pharmaceutical rebates of uninsured plans shall be recorded on the financial statements of the reporting entity. Any pharmaceutical rebates earned by the reporting entity that are in excess of the amounts to be remitted to the uninsured plan pursuant to an administrative services agreement shall be determined consistent with the requirements of paragraphs 12 and 13 and shall be reported on the balance sheet as an amount receivable relating to uninsured accident and health plans, and as a reduction to general expenses on the statement of operations.

**Claim Overpayment Receivables**

16. A claim overpayment shall not be recorded as a receivable until invoiced. To the extent that the claim overpayment meets the setoff conditions in SSAP No. 64 and the overpayment is a specific
identifiable payment and not an estimate, the receivable may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding incurred but not reported claims). The receivable and payable shall be reported gross rather than netted on the balance sheet. Evaluation of the collectibility of claim overpayment receivables shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted as they are not available to satisfy policyholder obligations.

Loans and Advances to Providers
17. Loans or advances to providers who meet the definition of related parties in SSAP No. 25 shall follow the guidance in that statement. To the extent a loan or advance to a non-related party provider meets the setoff conditions in SSAP No. 64, the loan or advance may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding incurred but not reported claims).

18. In addition, a loan or advance to a non-related party hospital shall be admitted up to the amount of claims incurred and payable to the hospital, if all of the following conditions are met:
   a. The loan or advance meets the setoff conditions in SSAP No. 64;
   b. The loan or advance is supported by a legally enforceable contract;
   c. The loan or advance is administered pursuant to contractual terms;
   d. The contractual terms of the agreement provide for separate quarterly reconciliations;
   e. Each quarterly reconciliation shall be completed within nine months of the end of such quarter; and
   f. A quarterly reconciled difference shall be settled within 90 days of the date the reconciliation is completed.

19. If a quarterly reconciliation is not performed or settled in accordance with paragraphs 18 e. and 18 f. above, all assets for loans or advances to that hospital shall be nonadmitted.

20. The receivable and payable shall be reported gross rather than netted on the balance sheet. Evaluation of the collectibility of loans and advances to providers shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted as they are not available to satisfy policyholder obligations.

Capitation Arrangement Receivables
21. Advances to providers under capitation arrangements that are made under the terms of an approved provider services contract in anticipation of future services shall be admitted to the extent that the advanced amount does not exceed one month of average capitation payments for the subject provider during the preceding twelve months, and provided that the contract cannot be terminated before the end of the month for which the advanced amount was paid. Evaluation of the collectibility of capitation arrangement receivables shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.
Risk Sharing Receivables

22. Risk sharing receivables may consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below:

a. Risk sharing receivables and payables shall only be recorded when reasonably estimated. Estimates of risk sharing receivables may be admitted if based on at least six months of actual claims experience for each risk sharing contract. The contractual terms of any risk sharing agreement shall provide for evaluation of the experience under the contract at least annually. The determination of the risk sharing balance shall commence no later than 6 months following the close of such annual period, and the balance shall be invoiced no later than 8 months following close of the annual period;

b. Billed amounts represent risk sharing receivables that have been invoiced but not collected as of the reporting date. Risk sharing receivables and payables shall be invoiced or refunded in accordance with the contractual provisions of the risk sharing agreement. Adjustments resulting in increases to previously billed amounts related to prior periods shall be nonadmitted until invoiced. Adjustments resulting in decreases to previously billed amounts shall be recognized immediately. Risk sharing receivables that have not been collected within 90 days of the date of invoicing shall be nonadmitted;

c. Risk sharing receivables and payables shall be reported gross rather than netted on the balance sheet. However, if a reporting entity has both a receivable and payable balance with the same provider and the balances meet the setoff conditions in SSAP No. 64, those balances shall be netted in accordance with SSAP No. 64; and

d. Evaluation of the collectibility of risk sharing receivables shall be made quarterly. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

23. The method used to reasonably estimate the receivable shall be consistent from period to period and shall be adjusted periodically for any changes in the underlying risk sharing contract. The financial statements shall disclose information regarding the reporting entity’s risk sharing receivables in accordance with paragraph 27 of this issue paper.

24. Income/expense from risk sharing contracts shall be reported as a component of claims expense on the summary of operations.

Amounts Receivable Under Government Insured Plans

25. Amounts receivable under government insured plans, including amounts over 90 days due, that qualify as accident and health contracts in accordance with SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force shall be admitted assets. Amounts receivable under government insured plans include but are not limited to receivables under Medicare, Medicaid and similarly funded government insured plans. Evaluation of the collectibility of amounts receivable under government insured plans shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.
Disclosures

26. The financial statements shall disclose the method used by the reporting entity to estimate pharmaceutical rebate receivables. Furthermore, for the most recent three years and for each quarter therein, the reporting entity shall also disclose the following:

   a. Estimated balance of pharmacy rebate receivables as reported on the financial statements;
   b. Pharmacy rebates as invoiced or confirmed in writing; and
   c. Pharmacy rebates collected.

   An example of this disclosure is shown in Exhibit A to this issue paper.

27. The financial statements shall disclose the method used by the reporting entity to estimate its risk sharing receivables. If any receivable and payable balances with the same provider are netted, the reporting entity shall disclose the gross receivable and payable balances in the notes to the financial statements. Furthermore, for the most recent three years, the reporting entity shall also disclose the following:

   a. Risk sharing receivables as estimated and reported on the prior year financial statements for annual periods ending in the current year;
   b. Risk sharing receivables as estimated and reported on the financial statements for annual periods ending in the current year and the following year;
   c. Risk sharing receivables invoiced as determined after the annual period;
   d. Risk sharing receivables not yet invoiced; and
   e. Amounts collected from providers as payments under risk sharing contracts.

   An example of this disclosure is shown in Exhibit B to this issue paper.

Effective Date and Transition

28. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2001.

29. Prior to January 1, 2003, reporting entities may transition the invoicing provision outlined in paragraph 12 and shall invoice pharmaceutical rebates on no less than a semi-annual basis. Furthermore, prior to January 1, 2003, reporting entities may transition the 90 day admissibility provision outlined in paragraph 12 and shall nonadmit pharmaceutical rebates if such rebates have not been collected within 180 days of the invoicing date.

30. Prior to January 1, 2003, reporting entities may transition the invoicing provision outlined in paragraph 22 and shall invoice the risk sharing balance no later than 11 months days following the close of the annual period.

DISCUSSION

31. The statutory accounting principles outlined above are consistent with the conservatism and recognition concepts in the Statement of Concepts, current statutory accounting guidance and SSAP No. 4.
Conservatism

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency.

Recognition

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

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

32. SSAP No. 47 paragraph 8 provides guidance on accounting for amounts receivable from uninsured plans:

8. Amounts receivable from uninsured plans for (a) claims and other costs paid by the administrator on behalf of the third party at risk and (b) fees related to services provided by the administrator to the plan meet the definition of assets as set forth in SSAP No. 4—Assets and Nonadmitted Assets. A receivable shall not be recorded for unpaid claims. A receivable related to Medicare or a similarly structured cost based reimbursement contract shall only be recorded when services have been rendered.

33. SSAP No. 47 paragraph 10 c. provides guidance on determining the nonadmitted portion of amounts receivable from Medicare and similar government funded uninsured plans:

10 c. Medicare and similar government funded plans—Amounts due related to Medicare and similar government plans shall not be nonadmitted when they become over ninety days due. Appropriate reserves shall be established to cover costs incurred which may not be reimbursed upon final determination by the governing agencies under the cost contract or for adjustments to revenues based on performance under the terms of the contract or other external factors.

34. SSAP No. 64 paragraph 2 provides guidance on accounting for offsetting and netting of assets and liabilities:

2. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 3 and 4. A right of setoff is a reporting entity’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt. A valid right of setoff exists only when all the following conditions are met:

   a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;

   b. The reporting party has the right to setoff the amount owed with the amount owed by the other party;

   c. The reporting party intends to setoff; and

   d. The right of setoff is enforceable at law.
35. SSAP No. 25 paragraphs 7 and 8 include the following guidance for loans or advances by a reporting entity:

7. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm’s-length transactions as defined in paragraph 10. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 10 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

8. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month’s payment shall be nonadmitted assets.

**Generally Accepted Accounting Principles**

36. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

5.01. Receivables may include amounts due for (a) health care services from patients, residents, third-party payors, and employers; (b) premiums and stop-loss insurance recoveries; (c) intercompany transactions; (d) promises to give in future periods (pledges); and (e) amounts due from employees, physicians, or others. All loans, such as loans to physicians, should be evaluated periodically for impairment. Loans that are included in the scope of FASB Statement No. 114, Accounting by Creditors for Impairments of a Loan, should be evaluated based on the provisions of that statement. A loan is impaired when, based on current information and events, it is probable that the provider will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement. If the provider measures an impaired loan using a present value amount, the creditor should calculate that present value based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan’s effective interest rate.

**RELEVANT LITERATURE**

**Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 4—Assets and Nonadmitted Assets
- SSAP No. 5—Liabilities, Contingencies and Impairment of Assets
- SSAP No. 20—Nonadmitted Assets
- SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- SSAP No. 47—Uninsured Plans
- SSAP No. 64—Offsetting and Netting of Assets and Liabilities

**Generally Accepted Accounting Principles**

- The AICPA Audit and Accounting Guide: Health Care Organizations

**State Regulations**

- No additional guidance obtained from state statutes or regulations
## ISSUE PAPER NO. 107 – EXHIBIT A – ILLUSTRATION OF PHARMACEUTICAL REBATE RECEIVABLES

(000 omitted)

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<tr>
<th>Quarter</th>
<th>Estimated Pharmacy Rebates as Reported on Financial Statements</th>
<th>Pharmacy Rebates as Invoiced/Confirmed</th>
<th>Actual Rebates Collected Within 90 Days of Invoicing/Confirmation</th>
<th>Actual Rebates Collected Within 91 to 180 Days of Invoicing/Confirmation</th>
<th>Actual Rebates Collected More Than 180 Days After Invoicing/Confirmation</th>
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### ISSUE PAPER NO. 107 – EXHIBIT B – ILLUSTRATION OF RISK SHARING RECEIVABLES

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<tr>
<th>Calendar Year</th>
<th>Evaluation Period Year Ending</th>
<th>Risk Sharing Receivable as Estimated and Reported in the Prior Year</th>
<th>Risk Sharing Receivable as Estimated and Reported in the Current Year</th>
<th>Risk Sharing Receivable Invoiced</th>
<th>Risk Sharing Receivable Not Invoiced</th>
<th>Actual Risk Sharing Amounts Collected First Year Subsequent</th>
<th>Actual Risk Sharing Amounts Collected Second Year Subsequent</th>
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**DRAFTING NOTE:** If there were only one contract or if all contracts have the same experience period, then there would only be an entry in either the “Invoiced” or “Not Invoiced” column for the current year. This example assumes varying dates on experience periods for multiple contracts.

Assumptions: Two risk sharing contracts are in place, one with an experience period that ends 3/31/03 and one with an experience period that ends 10/31/03.

The $155,000 receivable for the contract period that ends 3/31/03 would be invoiced no later than 11/30/03 (or 8 months days following close of the contract period) and could be received no later than 2/28/04. Therefore, the $155,000 would appear in the “Invoiced” column in 2003 but not shown as received in 2003. Further, the $189,000 estimate for the experience period that ends 3/31/04 could be recorded on the December 31, 2003 financial statement, since there is more than six months of experience under the contract.

The contract with the experience period that ends 10/31/03 with an estimated $77,000 receivable would be invoiced by 6/30/04 and received by 09/30/04. Therefore, it would appear in the “Not Invoiced” column and not shown as received in 2003. However, no estimate could be reported on the December 31, 2003 financial statement for the experience period that ends 10/31/04, because there is less than six months of experience under the contract.
Statutory Issue Paper No. 108

Multiple Peril Crop Insurance

STATUS
Finalized September 12, 2000

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Farming has always been an inherently risky enterprise because farmers operate at the mercy of nature and frequently are subjected to weather-related perils such as droughts, floods, hurricanes, and other natural disasters. Since the 1930s, many farmers have been able to transfer part of the risk of loss in production to the federal government through the subsidized Multiple Peril Crop Insurance (MPCI) program administered by the Federal Crop Insurance Corporation (FCIC), an agency of the United States Department of Agriculture. Major legislation enacted in 1980 and 1994 restructured the MPCI program. The 1980 legislation enlisted, for the first time, private insurance companies to sell, service, and share the risk of MPCI insurance policies. Subsequently, in 1994, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act revised the program to offer farmers two primary levels of insurance coverage, catastrophic and buy-up.

2. Catastrophic insurance is designed to provide farmers with protection against extreme crop losses for a small processing fee. Buy-up insurance provides protection against more typical and smaller crop losses in exchange for a policyholder-paid premium. The government subsidizes the total premium for catastrophic insurance and a portion of the premium for buy-up insurance. Farmers who purchase buy-up crop insurance must choose both the coverage level (the proportion of the crop to be insured) and the unit price (such as, per bushel) at which any loss is calculated. With respect to the coverage level of production, farmers can choose to insure as much as 85 percent of normal production or as little as 50 percent of normal production at different price levels. With respect to the unit price, farmers choose whether to value their insured production at FCICs full estimated market price or at a percentage of the full price.

3. In recent years, FCIC has introduced a new risk management tool called revenue insurance. Unlike traditional crop insurance, which insures against losses in the level of crop production, revenue insurance plans insure against losses in revenue. The plans protect the farmer from the effects of declines in crop prices or declines in crop yields, or both. Like traditional buy-up insurance, the government subsidizes a portion of the premiums. One of the plans, called Crop Revenue Coverage, is available in many states for major crops. Two other plans, called Income Protection and Revenue Assurance, are available to farmers in only limited areas.

4. Companies participate in the MPCI program with FCIC through the Standard Reinsurance Agreement (SRA) per the terms of which the insurance companies share in the underwriting results of each policy. In 1999, MPCI gross written premium was $2.3 billion and total insurance in force amounted to over $30.9 billion. The program has unique loss exposure characteristics, which resulted in a gross loss ratio over 200% for 1988 and 1993.

5. The SRA reinsurance terms provide a company the flexibility to limit its exposure on a state by state basis. MPCI premium is not expense loaded, therefore FCIC pays the insurance companies, on behalf of the policyholder, a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims.
6. The FCIC utilizes an escrow account to distribute or collect additional funds. Premium (collected from the policyholders and the federal government subsidy) is deposited in the escrow account and is available to pay the claims arising under the program.

7. Existing statutory accounting practices do not address the distinctive characteristics of the MPCI line of business. Current practices within the industry vary. Accordingly, this issue paper establishes statutory accounting principles for direct MPCI premium written and the related business ceded to FCIC, and is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. This issue paper also establishes statutory accounting principles for the recently enacted Aquatic Crop Reinsurance Agreement (hereinafter included in the term MPCI).

8. Commercial multiple-peril crop reinsurance and crop hail insurance would not be impacted by this issue paper and would continue to follow existing statutory accounting principles.

SUMMARY CONCLUSION

Premium Recognition
9. MPCI gross premium is defined as the contractually determined amount specified by FCIC to the policyholder for the effective period of the contract based on the actuarially determined expectation of risk and policy benefits associated with the coverage provided by the terms of the insurance contract. In addition, gross premium shall also include the government premium subsidy paid on behalf of the policyholder.

10. MPCI ceded premium and losses are defined as the amount calculated by applying the proportional and non-proportional factors as stated in the SRA. An example of this application is shown in Exhibit A to this issue paper.

11. MPCI written premium shall be recorded as soon as an estimate can be made, but no later than the processing date. Upon recording written premium, a liability for the unearned premium reserve shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

12. The company shall disclose the method used to compute the unearned premium reserve in the financial statements.

Amounts Receivable or Payable
13. The company shares underwriting risk with FCIC and can earn or lose money according to the claims it must pay farmers for crop losses. The company earns underwriting profits when the net retained premiums exceed the net crop loss claims paid. The company incurs underwriting losses when the net claims paid for crop losses exceed the net retained premiums. These definitions do not consider underwriting expenses, which would be included for traditional statutory accounting underwriting gains and losses. The use of the terms underwriting gains and losses in this issue paper are unique to the MPCI program. As the premiums of the program are held by FCIC in escrow, the company shall recognize as a write-in asset a receivable from FCIC for the amount of the underwriting gain (as defined in this paragraph). Whereas, when the company is in an underwriting loss position, the company shall recognize a write-in liability to the FCIC for the amount of the underwriting loss (as defined in this paragraph), as the monies held in the escrow account are not sufficient to cover the company’s claims. In accordance with the SRA, funds that remain in escrow will be distributed to the company at the conclusion of the contract period if the contract results in a gain to the company. If the company owes additional funds to the escrow (i.e., it is in a loss position), those funds are remitted on a periodic basis until the contract expires. These amounts shall be recorded net as the program meets the requirements of offsetting as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64). In accordance with SSAP No. 21—Other Admitted Assets (SSAP No. 21), the amount receivable under the Federal Crop Insurance program shall be reported as an admitted asset.
14. Amounts receivable from policyholders meet the definition of an admitted asset as set forth in SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) and should be accounted for in accordance with SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers (SSAP No. 6). The due date shall be governed by contractual due date of the premium billing, and not the effective date of the contract.

Unpaid Losses and Loss Adjustment Expenses
15. In accordance with SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses (SSAP No. 55), losses and loss adjustment expenses shall be recognized as expense when a covered or insured event occurs.

16. The covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event, it is necessary to establish a liability. The following are the types of future costs relating to the MPCI program:

a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the insurer as of the statement date;

b. Incurred But Not Reported Losses, (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the insurer as of the statement date;

c. Loss Adjustment Expenses: Costs expected to be incurred in connection with the adjustment and recording of losses defined in subparagraphs 16a. and 16b. of this issue paper.

Administrative Expense Payment
17. FCIC pays the insurance companies a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The expense payment associated with the catastrophic coverage shall be recorded as a reduction of loss expenses whereas the expense payment for the buy-up coverage shall be recorded as a reduction of other underwriting expenses. The company shall disclose the total amounts received for each type of coverage.

Escrow Account
18. The escrow account shall not be recorded on the financial statements of the insurance company. This account is considered an FCIC account and as such is not owned by the insurance company, however, the company’s underwriting gain is reflected as a receivable in accordance with paragraph 13.

Effective Date
19. This issue paper is effective for SRA contracts entered into after January 1, 2001. A change resulting from the adoption of this issue paper shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Correction of Errors.

DISCUSSION
20. The conclusions reached in this issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. The issue paper also relies on the conclusions reached in various other issue papers. Due to the unique terms and complicated provisions in the MPCI program and the SRA, there is very little specific guidance for insurers when accounting for MPCI premiums and losses.

21. The definition of gross premium is consistent with the contractual provisions of the MPCI program. The policyholder pays a portion of the buy-up coverage with the remainder subsidized by FCIC. As such it is consistent and reasonable to report both components as gross premium. The ceded premium is computed using the factors given in the SRA. The SRA is unlike traditional reinsurance agreements in that it includes both proportional and non-proportional coverage within the same agreement contingent upon underwriting...
results. As such, it is essential that each company compute and report ceded premiums consistently. Exhibit A is included to provide an illustration of the computation. Written premium in this issue paper is accounted for differently than SSAP No. 53—Property Casualty Contracts - Premiums (SSAP No. 53). SSAP No. 53 states that written premium shall be recorded on the effective date of the contract whereas this issue paper states that written shall be recorded on the processing date. This difference is due to the fact that policyholders engage in the contracts before they know how much acreage will be covered under the contract. Once the crops have been planted, an acreage report is generated which is used to compute the premium due under the contract. Therefore, it would be unreasonable for the insurance company to record written premium on the effective date, as the premium is not yet determinable.

22. The amounts receivable or payable from FCIC are addressed in SSAP No. 21. SSAP No. 21 states that amounts receivable from Federal Crop Insurance programs shall be reported as admitted assets. The amount receivable from policyholders is addressed in SSAP No. 6. This issue paper clarifies that the due date of the receivable shall be governed by the contractual due date of the premium billing as the premiums are computed months after the contracts are effective. If the receivables were aged as of the effective date, they could be non-admitted before they billed.

23. Unpaid losses and loss adjustment expenses shall be recorded consistent with SSAP No. 55. The conclusions reached in SSAP No. 55 are consistent with the provisions of the MPCI program.

24. FCIC pays the insurance companies a percent of premium for the administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The requirement to show these payments as reductions in loss adjustment expenses and other underwriting expenses is because the MPCI premium is not expense loaded. Some companies simply pass these payments to the agents in lieu of commissions. In that case, the remittance would then also be recorded as an increase in other underwriting expenses (i.e., commission expense) and there would be no effect on net income.

Drafting Notes/Comments
25. Companies writing MPCI as their predominate line of insurance can experience distorted Insurance Regulatory Information System (IRIS) ratios based upon the accounting for this line of business. The acceptable ranges for the IRIS ratios should either be changed or the ratios should be footnoted by NAIC based upon the uniqueness on the MPCI line of insurance. The IRIS ratios most often affected are gross premiums to surplus, agent’s balances to surplus, and liabilities to liquid assets.


RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
Statutory literature does not specifically address the MPCI program.

Generally Accepted Accounting Principles
GAAP literature does not specifically address the MPCI program.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 3—Accounting Changes and Corrections or Errors
- SSAP No. 4—Definition of Assets and Nonadmitted Assets
- SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers
- SSAP No. 21—Other Admitted Assets
- SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- SSAP No. 62—Property and Casualty Reinsurance
- SSAP No. 64—Offsetting and Netting of Assets and Liabilities

**Generally Accepted Accounting Principles**
- No further guidance obtained from GAAP literature

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

**Other Sources of Information**
- United States General Accounting Office Testimony Before the Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, March 17, 1999
- KPMG Peat Marwick Multi-Peril Crop Insurance Revenue Recognition Survey, December 18, 1996
EXHIBIT A - ILLUSTRATION OF CEDED PREMIUMS AND LOSSES

NOTES TO THE ILLUSTRATION

Fund  The reinsurance fund specified in the Standard Reinsurance Agreement (SRA).

Column 1  Reinsured Company proportional reinsurance retention percentage.

Column 2  Gross Written Premium equals the insured paid premium amount plus premium subsidy provided by FCIC.

Column 3  Net Retained Premium is the Reinsured Company retained premium after proportional reinsurance. Gross Written Premium (Column 2) times the Reinsured Company retention percentage (Column 1).

Column 4  Proportional Ceded Premium is the premium retained by FCIC after proportional reinsurance. Gross Written Premium (Column 2) minus the Reinsured Company Net Retained Premium (Column 3).

Column 5  Reinsured Company proportional reinsurance retention percentage (Column 1).

Column 6  Gross Losses equals total claim payments to insured.

Column 7  Net Retained Losses are the Reinsured Company retained losses after proportional reinsurance. Gross Losses (Column 6) times the Reinsured Company retention percentage (Column 5).

Column 8  Proportional Ceded Losses are the losses retained by FCIC after proportional reinsurance. Gross Losses (Column 7) minus the Reinsured Company Net Retained Losses (Column 7).

Column 9  Retained Loss Ratio is the Reinsured Company's Net Retained Losses (Column 7) divided by the Reinsured Company's Net Retained Premium (Column 3).

Column 10  Underwriting (Gain)/Loss is the Reinsured Company share of the MPCI program gain or loss after calculating the non-proportional reinsurance provided in the SRA.

Column 11  Non-Proportional Ceded Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting (Gain) (Column 10) if one exists. This is FCIC’s share of the underwriting gain after proportional reinsurance, based on the non-proportional reinsurance gain sharing factors specified in the SRA.

Column 12  Non-Proportional Ceded Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting Loss (Column 10) if one exists. This is FCIC’s share of the underwriting loss after proportional reinsurance, based on the non-proportional reinsurance loss sharing factors specified in the SRA.

Column 13  Final Retained Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Premium (Column 11). The Reinsured Company Net Retained Premium after proportional reinsurance is reduced by the amount of FCIC’s underwriting gain share after non-proportional reinsurance.
Column 14  Final Retained Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Losses (Column 12). The Reinsured Company Net Retained Losses after proportional reinsurance are reduced by the amount of FCIC's underwriting loss share after non-proportional reinsurance.

Column 15  Final Retained Loss Ratio is equal to Final Retained Losses divided by Final Retained Premium.

(a)  Calculated based on the loss ratios for each fund by state. Net Retained Premium (Col 3) is applied to the percentages of Section II. C. and D. of the Standard Reinsurance Agreement.

(b)  If the fund is in a GAIN position then there would be Non-proportional ceded premium. If the fund is in a LOSS position then there would be Non-proportional ceded losses.

Since each fund and state stands alone in the calculations, there is a possibility of Non-proportional ceded premium AND ceded losses within the same reinsurance year. There is also the possibility of this within the same fund (some states with a Gain and some states with a Loss).
### Exhibit A - Illustration of Ceded Premiums and Losses

<table>
<thead>
<tr>
<th>Fund</th>
<th>Fund Retention</th>
<th>Gross Written Premium</th>
<th>Net Retained Premium</th>
<th>Proportional Ceded Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assigned Risk</td>
<td>20%</td>
<td>20,000,000</td>
<td>4,000,000</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Developmental</td>
<td>35%</td>
<td>10,000,000</td>
<td>3,500,000</td>
<td>6,500,000</td>
</tr>
<tr>
<td>Dev - CRC</td>
<td>35%</td>
<td>5,000,000</td>
<td>1,750,000</td>
<td>3,250,000</td>
</tr>
<tr>
<td>Dev - CAT</td>
<td>35%</td>
<td>5,000,000</td>
<td>1,750,000</td>
<td>3,250,000</td>
</tr>
<tr>
<td>Commercial</td>
<td>100%</td>
<td>100,000,000</td>
<td>100,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Comm - CRC</td>
<td>100%</td>
<td>20,000,000</td>
<td>20,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Comm - CAT</td>
<td>100%</td>
<td>40,000,000</td>
<td>40,000,000</td>
<td>0</td>
</tr>
</tbody>
</table>

Total Premium: 200,000,000

<table>
<thead>
<tr>
<th>Fund</th>
<th>Fund Retention</th>
<th>Gross Losses</th>
<th>Net Retained Losses</th>
<th>Proportional Ceded Losses</th>
<th>Retained Loss Ratio</th>
<th>Underwriting Gain/Loss (a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assigned Risk</td>
<td>20%</td>
<td>40,000,000</td>
<td>8,000,000</td>
<td>32,000,000</td>
<td>200.0%</td>
<td>184,000</td>
</tr>
<tr>
<td>Developmental</td>
<td>35%</td>
<td>16,000,000</td>
<td>5,600,000</td>
<td>10,400,000</td>
<td>160.0%</td>
<td>525,000</td>
</tr>
<tr>
<td>Dev - CRC</td>
<td>35%</td>
<td>7,000,000</td>
<td>2,450,000</td>
<td>4,550,000</td>
<td>140.0%</td>
<td>210,000</td>
</tr>
<tr>
<td>Dev - CAT</td>
<td>35%</td>
<td>4,000,000</td>
<td>1,400,000</td>
<td>2,600,000</td>
<td>80.0%</td>
<td>(157,500)</td>
</tr>
<tr>
<td>Commercial</td>
<td>100%</td>
<td>80,000,000</td>
<td>80,000,000</td>
<td>0</td>
<td>80.0%</td>
<td>(18,800,000)</td>
</tr>
<tr>
<td>Comm - CRC</td>
<td>100%</td>
<td>18,000,000</td>
<td>18,000,000</td>
<td>0</td>
<td>90.0%</td>
<td>(1,880,000)</td>
</tr>
<tr>
<td>Comm - CAT</td>
<td>100%</td>
<td>22,000,000</td>
<td>22,000,000</td>
<td>0</td>
<td>55.0%</td>
<td>(12,500,000)</td>
</tr>
</tbody>
</table>

Total Losses: 187,000,000

<table>
<thead>
<tr>
<th>Fund</th>
<th>Non-Proportional Ceded Premium (b)</th>
<th>Non-Proportional Ceded Premium Losses (b)</th>
<th>Final Retained Premium (Col 3 - Col 7)</th>
<th>Final Retained Losses (Col 7 - Col 12)</th>
<th>Final Retained Loss Ratio (Col 14/Col 13)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assigned Risk</td>
<td>0</td>
<td>3,816,000</td>
<td>4,000,000</td>
<td>4,184,000</td>
<td>104.6%</td>
</tr>
<tr>
<td>Developmental</td>
<td>0</td>
<td>1,575,000</td>
<td>3,500,000</td>
<td>4,025,000</td>
<td>115.0%</td>
</tr>
<tr>
<td>Dev - CRC</td>
<td>0</td>
<td>490,000</td>
<td>1,750,000</td>
<td>1,960,000</td>
<td>112.0%</td>
</tr>
<tr>
<td>Dev - CAT</td>
<td>192,500</td>
<td>0</td>
<td>1,557,500</td>
<td>1,400,000</td>
<td>89.9%</td>
</tr>
<tr>
<td>Commercial</td>
<td>1,200,000</td>
<td>0</td>
<td>98,800,000</td>
<td>80,000,000</td>
<td>81.0%</td>
</tr>
<tr>
<td>Comm - CRC</td>
<td>120,000</td>
<td>0</td>
<td>19,880,000</td>
<td>18,000,000</td>
<td>90.5%</td>
</tr>
<tr>
<td>Comm - CAT</td>
<td>5,500,000</td>
<td>0</td>
<td>34,500,000</td>
<td>22,000,000</td>
<td>63.8%</td>
</tr>
</tbody>
</table>

Total: 7,012,500

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Statutory Issue Paper No. 109

Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software

STATUS
Finalized September 12, 2000

Type of Issue:
Common

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principle No. 16—Electronic Data Processing Equipment and Software (SSAP No. 16) requires depreciation of all electronic data processing (EDP) equipment and software for a period not to exceed three years. This requirement is applicable to both operating and nonoperating system software.

2. The purpose of this issue paper is to amend SSAP No. 16 to allow the depreciation of nonoperating system software over the lesser of its useful life or five years rather than three years. The conclusions outlined in this issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. This issue paper amends paragraph 3 and 8 of SSAP No. 16. The following guidance shall be followed for depreciation of EDP equipment, operating system software and nonoperating system software.

4. EDP equipment and operating system software shall be depreciated over the lesser of its useful life or three years. Nonoperating system software shall be depreciated over the lesser of its useful life or five years. In either case, the methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements shall be used.

Effective Date

5. EDP equipment and operating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or three years. Nonoperating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or five years.

DISCUSSION

6. A different amortization period for nonoperating system software, often called “applications software,” was not discussed during the initial drafting of SSAP No. 16. The amortization period for admitted EDP and software was discussed as part of the overall debate about whether any or all EDP and operating systems software should be an admitted asset. Amortization of nonoperating system software over a five year period does not violate the Statement of Concepts as illustrated below:

   a. Allowing amortization of nonoperating system software over its useful life by an appropriate method requires an insurer to appropriately recognize the expense and its income effect over time;
b. The statutory accounting concept of conservatism is served by continuing to nonadmit nonoperating system software. It is not violated by allowing amortization over a longer period of time than three years if that period is no longer than the software's useful life; and

c. Implementation of SSAP No. 16 as drafted may adversely affect companies and regulators by requiring insurers to accelerate expense recognition in a manner that was not foreseen. A number of states allow amortization of admitted EDP equipment and software over periods as long as 10 years, and current statutory accounting (prior to implementation of SSAP No. 16) provides the option of amortizing nonoperating systems software over its useful life. In addition, the initial draft of Issue Paper No. 16 allowed depreciation of nonadmitted EDP and software against net income as the estimated economic benefit expired. In 1999 insurers made significant purchases of nonoperating system software, in many cases to ensure that the software was not subject to the “year 2000 problem.”

7. SSAP No. 16 currently requires EDP equipment and software capitalized prior to January 1, 2001 to be depreciated over the lesser of its remaining useful life or three years; therefore it is important that this issue paper be implemented concurrently with the effective date of SSAP No. 16.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. SSAP No. 16 paragraphs 3 and 8:

3. EDP equipment and software shall be depreciated for a period not to exceed three years using methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements.

8. EDP equipment and software capitalized prior to January 1, 2001 shall be depreciated over the shorter of its remaining useful life or three years.

Generally Accepted Accounting Principles
9. GAAP does not address the issue of different depreciation periods for operating and nonoperating system software.

Drafting Notes/Comments
- AICPA Statement of Position 98-1: Accounting for Costs of Computer Software Developed or Obtained for Internal Use will be addressed in a separate issue paper.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 16—Electronic Data Processing Equipment and Software
- SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements
Statutory Issue Paper No. 110

Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 56—Separate Accounts

STATUS
Finalized September 12, 2000

Type of Issue:
Life

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principles No. 51—Life Contracts (SSAP No. 51) prescribes the accounting treatment for life contracts, SSAP No. 52—Deposit-Type Contracts (SSAP No. 52) prescribes the accounting treatment for deposit-type contracts, and SSAP No. 56—Separate Accounts (SSAP No. 56) prescribes the accounting treatment for separate accounts.

2. The purpose of this issue paper is to amend SSAP No. 51, SSAP No. 52 and SSAP No. 56 to incorporate the guidance included in appendices A-200, A-695 and A-830 and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Statutory policy reserves for those group annuity contracts or other contracts that, in whole or in part, establish the insurer’s obligations by reference to a segregated portfolio of assets not owned by the insurer shall be established in accordance with the guidance in Appendix A-695.

4. Statutory policy reserves for those contracts with nonlevel premiums or benefits, or contracts with secondary guarantees shall be established in accordance with the guidance in Appendix A-830.

5. Statutory policy reserves for those group life contracts utilizing a separate account that meet the requirements outlined in paragraph 1 of Appendix A-200 shall be computed in accordance with the guidance in that appendix.

6. This issue paper amends paragraph 43 of SSAP No. 51 to the following:


7. This issue paper amends paragraph 19 of SSAP No. 52 to the following:


8. This issue paper amends the first sentence of paragraph 23 of SSAP No. 56 to the following:

9. This issue paper amends paragraph 30 of SSAP No. 56 to the following:


Effective Date
10. This issue paper is effective for years beginning January 1, 2001. Contracts issued prior to January 1, 2001 shall be accounted for based on the laws and regulations of the domiciliary state.

DISCUSSION
11. Subsequent to the NAIC’s adoption of SSAP No. 51, SSAP No. 52, and SSAP No. 56, the NAIC adopted the Separate Accounts Funding Guaranteed Minimum Benefits Under Group Contracts Model Regulation, the Synthetic Guaranteed Investment Contracts Model Regulation, and the Valuation of Life Insurance Policies Model Regulation. Appendices A-200, A-695 and A-830 excerpt the accounting guidance from each of these three model regulations, respectively. This issue paper incorporates the requirements of these appendices.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
12. SSAP No. 51 paragraph 43:


13. SSAP No. 52, paragraph 19:


14. SSAP No. 56, paragraph 23:

23. The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendices A-250, A-270, A-255, A-585, A-588, A-620, A-820, A-822, and the actuarial guidelines found in Appendix C of this Manual. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at market). Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

15. SSAP No. 56, paragraph 30:


RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force
Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 56—Separate Accounts

- SSAP No. 51—Life Contracts
- SSAP No. 52—Deposit-Type Contracts
- SSAP No. 56—Separate Accounts

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments
- FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts
- AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises
- FASB Interpretation No. 40, Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113
- AICPA Practice Bulletin 8, Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 111

Software Revenue Recognition

STATUS
Finalized December 4, 2000

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. During the development of the initial Statements of Statutory Accounting Principles (SSAP) issues related to software revenue recognition were deemed to be not applicable to statutory accounting. Since the development of the initial SSAPs, significant changes have occurred in the world of technology and the opportunities available to insurance entities to license, sell, lease or otherwise market computer software have greatly expanded.

2. Generally Accepted Accounting Principles (GAAP) guidance for software revenue recognition was originally addressed in Statement of Position (SOP) 91-1, Software Revenue Recognition. SOP 91-1 was published to provide guidance on applying GAAP to software transactions and to narrow the range of revenue recognition practices that were in use before its issuance. Since the distribution of SOP 91-1, practice issues have been identified that are not addressed adequately in SOP 91-1. Therefore, the American Institute of Certified Public Accountants (AICPA) issued SOP 97-2, Software Revenue Recognition to replace SOP 91-1. SOP 97-2 has been modified by the issuance of SOP 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. SOP 97-2 has also been interpreted by the Emerging Issues Task Force (EITF) 00-3, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware.

3. The purpose of this issue paper is to address SOP 97-2, SOP 98-4, SOP 98-9 and EITF 00-3 and establish statutory accounting principles that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

4. This issue paper adopts SOP 97-2 paragraphs 6 through 91 with certain modifications, SOP 98-9 paragraphs 6 through 8 and EITF 00-3. This issue paper rejects SOP 98-4 as not applicable because the effective date of the corresponding SSAP is expected to be January 1, 2002.

5. The modifications to SOP 97-2 are as follows:

a. Paragraph 10 is amended to require that entities follow the guidance outlined in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets rather than Statement of Financial Accounting Standard (FAS) No. 5, Accounting for Contingencies;

b. Paragraph 33 is amended to remove the reference to Technical Bulletin (TB) No. 79-10: Fiscal Funding Clauses in Lease Agreements;

c. Paragraph 57 is amended to remove the reference to FAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed;
**Effective Date and Transition**

6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2002.

**DISCUSSION:**

7. The modifications to SOP 97-2 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts.

a. Paragraph 10 is amended because it includes a reference to FAS No. 5, *Accounting for Contingencies*. SSAP No. 5—*Liabilities, Contingencies and Impairments of Assets* contains the authoritative statutory accounting for loss contingencies;

b. Paragraph 33 is amended because it includes a reference to TB No. 79-10. The removal of the reference does not change the accounting prescribed in SOP 97-2 and it eliminates any possible conflict with the fact that TB No. 79-10 is rejected by SSAP No. 22—*Leases*;

c. Paragraph 57 was amended because it includes a reference to FAS No. 86. Paragraph 57 is not impacted by the removal of FAS No. 86 because it is used in the context of a piece of historical evidence. SSAP No. 17—*Preoperating and Research and Development Costs* requires all such costs to be expensed, therefore there is no capitalization experience to analyze;

d. Paragraph 73 was deemed to be not applicable because of the requirement to follow FAS No. 86 in the case of capitalizing funded software-development costs. This approach is inconsistent with the provisions of SSAP No. 17 and the requirement to expense such costs. The directive to expense such costs eliminates the need for this paragraph.

8. SOP 98-4 as well as the effective date paragraphs of SOP 97-2 and SOP 98-9 were not adopted in this issue paper as it is expected that the effective date for the SSAP will be January 1, 2002.

9. EITF 00-3 was adopted because it supports the principles adopted in SOP 97-2.

10. SOP 97-2 includes several references to GAAP pronouncements that were deemed not applicable in the initial SSAPs. This includes Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*, SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, FAS No. 48, *Revenue Recognition When Right of Return Exists* and FAS 68, *Research and Development Arrangements*. These GAAP pronouncements are deemed to be applicable to statutory accounting only to the extent that SOP 97-2 references them.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting

11. In general, the initial SSAPs deemed the relevant GAAP guidance to be not applicable to statutory accounting. As discussed above, technology and the environment have changed significantly since the original SSAPs were adopted and therefore guidance is now needed.

Generally Accepted Accounting Principles

12. *AICPA Statement of Position 97-2, Software Revenue Recognition* provides the following:

Conclusions

.06 The following conclusions should be read in conjunction with the Basis for Conclusions section, beginning with paragraph .93 of this SOP, and the examples in appendix A, Examples of the Application of Certain Provisions of this SOP.

Basic Principles

.07 Software arrangements range from those that provide a license for a single software product to those that, in addition to the delivery of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, using the relevant guidance herein, and in SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts.

.08 If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.

• Persuasive evidence of an arrangement exists.
• Delivery has occurred.
• The vendor’s fee is fixed or determinable.
• Collectibility is probable.

.09 Software arrangements may provide licenses for multiple software deliverables (for example, software products, upgrades/enhancements, PCS, or services), which are termed multiple elements. A number of the elements may be described in the arrangement as being deliverable only on a when-and-if-available basis. When-and-if-available deliverables should be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.

.10 If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

• The price charged when the same element is sold separately
• For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace

The amount allocated to undelivered elements is not subject to later adjustment. However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss should be recognized pursuant to FASB Statement No. 5, Accounting for Contingencies. When a vendor’s pricing is based on multiple factors such as
the number of products and the number of users, the amount allocated to the same element when sold separately must consider all the factors of the vendor’s pricing structure.

.11 If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount should be applied to each element included in the arrangement based on each element’s fair value without regard to the discount. However, as discussed in paragraph .37, no portion of the discount should be allocated to any upgrade rights. Moreover, to the extent that a discount exists, the residual method described in paragraph .12 attributes that discount entirely to the delivered elements.

.12 If sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The following exceptions to this guidance are provided.

• If the only undelivered element is PCS, the entire fee should be recognized ratably (see paragraphs .56 through .62).
• If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee should be recognized over the period during which the services are expected to be performed (see paragraphs .63 through .71).
• If the arrangement is in substance a subscription, the entire fee should be recognized ratably (see paragraphs .48 and .49).
• If the fee is based on the number of copies, the arrangement should be accounted for in conformity with paragraphs .43 through .47.
• There may be instances in which there is vendor-specific objective evidence of the fair values of all undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

.13 The portion of the fee allocated to an element should be recognized as revenue when the criteria in paragraph .08 of this SOP are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the customer would not have the full use of the delivered element.

.14 No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. In order for the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence should be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may be persuasive, the following additional items should be considered:

• Acknowledgment in the arrangement of products not currently available or not to be delivered currently
• Separate prices stipulated in the arrangement for each deliverable element
• Default and damage provisions as defined in the arrangement
• Enforceable payment obligations and due dates for the delivered elements that are not dependent on the delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment
• Installation and use of the delivered software
• Support services, such as telephone support, related to the delivered software being provided currently by the vendor

Regardless of the preceding, the vendor’s historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements should be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

Evidence of an Arrangement

.15 Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.

.16 If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or on-line authorization). If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties.

.17 Even if all other requirements set forth in this SOP for the recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

Delivery

.18 The second criterion in paragraph .08 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a user or a reseller. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion of paragraph .08 is considered to have been met when the customer either (a) takes possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware), or (b) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. In such cases, revenue should be recognized if the other criteria of paragraph .08 have been satisfied.

.19 Paragraphs .20 through .25 provide guidance on determining whether delivery is considered to have occurred in certain kinds of software transactions.

Customer Acceptance

.20 After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs.

Determining Delivery—Multiple Copies of Software Products Versus Multiple Licenses

.21 Arrangements to use multiple copies of a software product under site licenses with users and to market multiple copies of a software product under similar arrangements with resellers should be distinguished from arrangements to use or market multiple single licenses of the same software.

• In the former kind of arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product master. The vendor may be obligated to furnish up to a specified number of
copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this SOP for revenue recognition are met, revenue should be recognized upon delivery of the first copy or product master. The estimated costs of duplication should be accrued at that time.

In the latter kind of arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue should be recognized as the copies are made by the user or sold by the reseller if the other criteria in this SOP for revenue recognition are met.

Delivery Other Than to the Customer

.22 Delivery should not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue should not be recognized until the delivery is made to that other site.

Delivery Agents

.23 Vendors may engage agents, often referred to as fulfillment houses, to either duplicate and deliver or only deliver software products to customers. Revenue from transactions involving delivery agents should be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

Authorization Codes

.24 In a number of software arrangements, vendors use authorization codes, commonly referred to as keys, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

.25 In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor should recognize revenue on delivery of the software if all other requirements for revenue recognition under this SOP and all of the following conditions are met.

- The customer has licensed the software and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).
- The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

In addition, if a temporary key is used to enhance the vendor's ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if (a) the above conditions are met and (b) the use of a temporary key in such circumstances is a customary practice of the vendor. Selective issuance of temporary keys might indicate that collectibility is not probable or that the software is being used only for demonstration purposes.
Fixed or Determinable Fees and Collectibility

.26 The other prerequisites in paragraph .08 for revenue recognition are that (a) the vendor’s fee is fixed or determinable and (b) collectibility is probable. A software licensing fee is not fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for variable-pricing arrangements is discussed in paragraphs .43 through .47 of this SOP. Additionally, if an arrangement includes (a) rights of return or (b) rights to refunds without return of the software, FASB Statement No. 48 requires that conditions that must be met in order for the vendor to recognize revenue include that the amount of future returns or refunds can be reasonably estimated.

Factors That Affect the Determination of Whether a Fee is Fixed or Determinable and Collectible

.27 A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product’s continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.

.28 For the reason cited in paragraph .27 any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than twelve months after delivery, the licensing fee should be presumed not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor should consider such fees fixed or determinable and should recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

.29 If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue should be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this SOP have been satisfied).

.30 For reseller arrangements, the following factors also should be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met.

• Business practices, the reseller’s operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller’s success in distributing individual units of the product.

• Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.

• Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery; examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.

• Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor’s ability to maintain its price, the
arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions of this SOP have been satisfied.

.31 Customer Cancellation Privileges. Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5. Additionally, short-term rights of return, such as thirty-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for in conformity with FASB Statement No. 48.

.32 Fiscal Funding Clauses. Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.

.33 Consistent with FASB Technical Bulletin No. 79-10, Fiscal Funding Clauses in Lease Agreements, a software licensing arrangement with a governmental unit containing a fiscal funding clause should be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency. If the likelihood is assessed as remote, the software licensing arrangement should be considered noncancelable. Such an assessment should include the factors discussed in paragraphs .27 and .28 of this SOP. If the likelihood is assessed as other than remote, the license should be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this SOP have been satisfied.

Multiple-Element Arrangements

.34 As discussed in paragraph .09, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or PCS. If contract accounting does not apply, individual elements in such arrangements should be accounted for in accordance with paragraphs .08 through .14. Paragraphs .35 through .73 provide guidance on the application of those paragraphs to multiple-element arrangements.

Additional Software Deliverables and Rights to Exchange or Return Software

.35 As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver additional software in the future. The additional deliverables may include upgrades/enhancements or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware platform or operating system to one or more other platforms or operating systems (a platform-transfer right).

.36 Upgrades/enhancements. As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an upgrade right for a specified upgrade/enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice. (Rights to receive unspecified upgrades/enhancements on a when-and-if-available basis are PCS, as it has been redefined in this SOP.) The upgrade right should be accounted for as a separate element in accordance with paragraphs .08 through .14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is given in paragraphs .37 and .38.
.37 If a multiple-element arrangement includes an upgrade right, the fee should be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph .11), no portion of the discount should be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right should be reduced to reflect that percentage. This estimated percentage should be reviewed periodically. The effect of any change in that percentage should be accounted for as a change in accounting estimate.

.38 The amount of the fee allocated to the upgrade right should be recognized as revenue when the conditions in paragraphs .08 through .14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered.

.39 Additional Software Products. As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a PCS arrangement or in a separate agreement. Even if the rights to the additional software products are included in a PCS arrangement, the revenue allocable to the additional software products should be accounted for separately from the PCS arrangement as an element of a multiple-element arrangement.

.40 Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs .48 and .49) should be accounted for in accordance with paragraphs .08 through .14 of this SOP. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs .41 through .47 below.

.41 The fee from the arrangement should be allocated among the products based on vendor-specific objective evidence of fair value. The allocation should be based on the relative sales prices (determined pursuant to paragraphs .10 and .11 of this SOP) of the products. If vendor-specific objective evidence of fair value does not exist, paragraph .12 of this SOP requires that all revenue from the arrangement be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The fee allocated to the additional software products should not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.

.42 If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product should be recognized as revenue when the product is delivered, assuming all other provisions of paragraphs .08 through .14 of this SOP are met.

.43 Some fixed fee license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph .46 of this SOP, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.
.44 In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs .08 through .14 of this SOP are met, revenue should be recognized as copies of delivered products either (a) are reproduced by the customer or (b) are furnished to the customer if the vendor is duplicating the software. Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized should be recognized. (At that point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraph .21 of this SOP, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor should recognize any licensing fees not previously recognized.

.45 The revenue from the kind of arrangements discussed in paragraph .44 should not be recognized fully until at least one of the following conditions is met.

- Delivery is complete for all products covered by the arrangement.
- The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

.46 Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

.47 The revenue allocated to the delivered products should be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue should be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) should be reduced by a corresponding amount.

.48 As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver unspecified additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs .50 through .55). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include PCS because the future deliverables are products, not unspecified upgrades/enhancements.

.49 The software elements of the kinds of arrangements discussed in paragraph .48 should be accounted for as subscriptions. No allocation of revenue should be made among any of the software products, and all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

.50 Rights to Exchange or Return Software. As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an
exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement should be accounted for in the manner prescribed in the section herein entitled “Additional Software Products” (see paragraphs .39 through .49). If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction should be accounted for either as a return or as an exchange, as discussed in the following paragraphs.

.51 If the rights discussed in the previous paragraph are offered to users (but not resellers), the exchanges are analogous to “exchanges by ultimate customers of one item for another of the same kind, quality, and price . . . [that] are not considered returns” described in footnote 3 of FASB Statement No. 48. Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48. If the other product(s) is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product should be considered to have more than a minimal difference in functionality.

.52 As part of a multiple-element arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right should be accounted for in the manner prescribed in the section herein entitled “Additional Software Products” (see paragraphs .39 through .49).

.53 If, as part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right, and the provisions of paragraphs .08 through .14 of this SOP are met, the revenue from the software license should be recognized upon the initial delivery of the software, and the exercise of the platform-transfer right should be treated as an exchange, if the platform-transfer right —
• Is for the same product (see paragraph .54)
• Does not increase the number of copies or concurrent users of the software product available under the license arrangement.

.54 Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of "marketed as the same product" include (a) the same product name (although version numbers may differ) and (b) a focus on the same features and functions.

.55 As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software (including software that runs on a different hardware platform or operating system). Because the reseller is not the ultimate customer (see paragraph .51), such exchanges, including those referred to as stock balancing arrangements, should be accounted for as returns. Arrangements that grant rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

Postcontract Customer Support

.56 Software arrangements may include the right to PCS. PCS includes the right to receive PCS services or unspecified upgrades/enhancements, or both, offered to users or resellers. A
vendor may develop historical patterns of regularly providing all customers or certain kinds of
customers with the services or unspecified upgrades/enhancements normally associated with
PCS, or may anticipate doing so, even though there is no written contractual obligation or the
stipulated PCS term commences at some date after delivery. In those situations, an implied PCS
arrangement exists that commences upon product delivery. For purposes of applying the
guidance in this SOP, PCS includes a vendor's expected performance based on such patterns,
even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.

.57 If a multiple-element software arrangement includes explicit or implicit rights to PCS, the
total fees from the arrangement should be allocated among the elements based on vendor-
specific objective evidence of fair value, in conformity with paragraph .10. The fair value of the
PCS should be determined by reference to the price the customer will be required to pay when it
is sold separately (that is, the renewal rate). The portion of the fee allocated to PCS should be
recognized as revenue ratably over the term of the PCS arrangement, because the PCS services
are assumed to be provided ratably. However, revenue should be recognized over the period of
the PCS arrangement in proportion to the amounts expected to be charged to expense for the
PCS services rendered during the period if—
- Sufficient vendor-specific historical evidence exists demonstrating that costs to
  provide PCS are incurred on other than a straight-line basis. In making this
determination, the vendor should take into consideration allocated portions of
cost accounted for as research and development (R&D) costs and the
amortization of costs related to the upgrade-enhancement capitalized in
conformity with FASB Statement No. 86, Accounting for the Costs of Computer
Software to Be Sold, Leased, or Otherwise Marketed. Such costs should be
considered as part of the costs to provide PCS.
- The vendor believes that it is probable that the costs incurred in performing
  under the current arrangement will follow a similar pattern.
Because the timing, frequency, and significance of unspecified upgrades/enhancements can vary
considerably, the point at which unspecified upgrades/enhancements are expected to be
delivered should not be used to support income recognition on other than a straight-line basis.

.58 If sufficient vendor-specific objective evidence does not exist to allocate the fee to the
separate elements and the only undelivered element is PCS, the entire arrangement fee should
be recognized ratably over (a) the contractual PCS period (for those arrangements with explicit
rights to PCS) or (b) the period during which PCS is expected to be provided (for those
arrangements with implicit rights to PCS).

.59 PCS revenue may be recognized together with the initial licensing fee on delivery of the
software if all of the following conditions are met.
- The PCS fee is included with the initial licensing fee.
- The PCS included with the initial license is for one year or less.
- The estimated cost of providing PCS during the arrangement is insignificant.
- Unspecified upgrades/enhancements offered during PCS arrangements
  historically have been and are expected to continue to be minimal and
  infrequent.
If PCS revenue is recognized upon the delivery of the software, the vendor must accrue all
estimated costs of providing the services, including upgrades/enhancements. Upgrades/enhancements
are not developed solely for distribution to PCS customers; revenues are expected to be earned from providing the enhancements to other customers as well.
Therefore, costs should be allocated between PCS arrangements and other licenses.

.60 A determination that unspecified upgrades/enhancements offered during the PCS
arrangement are expected to be minimal and infrequent should be evidenced by the patterns of
minimal and infrequent unspecified upgrades/enhancements offered in previous PCS
arrangements. A conclusion that unspecified upgrades/enhancements are expected to be
minimal and infrequent should not be reached simply because unspecified
upgrades/enhancements have been or are expected to be offered less frequently than on an
annual basis. Regardless of the vendor's history of offering unspecified upgrades/enhancements
to initial licensees, PCS should be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades/enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the PCS arrangement.

.61 Postdelivery Telephone Support at No Additional Charge. Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this SOP, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the PCS may be considered to have a term of one year or less in applying paragraph .59, item (b) of this SOP. Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph .59 of this SOP are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor should accrue the estimated cost of providing that support.

.62 PCS Granted by Resellers. An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades/enhancements to the reseller’s customers is an implied PCS arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller’s customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the PCS, revenue from both the licensing arrangement and the PCS should be recognized ratably over the period during which PCS is expected to be provided.

Services

.63 Certain arrangements include both software and service elements (other than PCS-related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

.64 If an arrangement includes such services, a determination must be made as to whether the service element can be accounted for separately as the services are performed. Paragraph .65 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting must be applied to both the software and service elements included in the arrangement. Paragraphs .74 through .91 of this SOP address the application of contract accounting to software arrangements.

.65 In order to account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value must exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs .10 and .12). Additionally, the services (a) must not be essential to the functionality of any other element of the transaction and (b) must be described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

.66 If an arrangement includes services that meet the criteria of paragraph .65 for separate accounting, revenue should be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element should be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

.67 If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve
significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee should be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee should be recognized on a straight-line basis over the period during which the services are performed.

.68 An important factor to consider in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered core or off-the-shelf software. Core software is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

.69 Software should be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement is not required to demonstrate that the customer could use the software off-the-shelf. If significant modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose (for example, changing or making additions to the software, or because it would not be usable in its off-the-shelf form in the customer's environment), the software should be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting should be applied to both the software and service elements of the arrangement.

.70 Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently should not be accounted for separately, include the following.

• The software is not off-the-shelf software.
• The services include significant alterations to the features and functionality of the off-the-shelf software.
• Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment.
• The timing of payments for the software is coincident with performance of the services.
• Milestones or customer-specific acceptance criteria affect the realizability of the software-license fee.

.71 Judgment is required in determining whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have one or more of the following characteristics.

• The services are available from other vendors.
• The services do not carry a significant degree of risk or unique acceptance criteria.
• The software vendor is an experienced provider of the services.
• The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.
• Customer personnel are dedicated to participate in the services being performed.

.72 Funded Software-Development Arrangements. Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:
• Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
• Discounts on future purchases by the funding party of products produced under the arrangement
• A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense)

.73 A funded software-development arrangement within the scope of FASB Statement No. 68, Research and Development Arrangements, should be accounted for in conformity with that Statement. If the technological feasibility of the computer software product pursuant to the provisions of FASB Statement No. 86 has been established before the arrangement has been entered into, FASB Statement No. 68 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this SOP. However, if capitalization of the software-development costs commences pursuant to FASB Statement No. 86, any income from the funding party under a funded software-development arrangement should be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess should be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) should be credited to income.

Contract Accounting

.74 If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph .65. The entire arrangement should be accounted for in conformity with ARB No. 45, using the relevant guidance in SOP 81-1. Nevertheless, transactions that normally are accounted for as product sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

.75 In applying contract accounting, the vendor must use either the percentage-of-completion method or the completed-contract method. The determination of the appropriate method should be made according to the recommendations in paragraphs 21 through 33 of SOP 81-1.

.76 Segmentation. Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 39 through 42 of SOP 81-1. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment should be measured in conformity with paragraphs .78 through .80 of this SOP.

.77 Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 40 of SOP 81-1 are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 41 of SOP 81-1.

.78 Measuring Progress-to-Completion Under the Percentage-of-Completion Method. Paragraph 46 of SOP 81-1 describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows.

• Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units
produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

For software contracts, an example of an input measure is labor hours; an example of an output measure is arrangement milestones, such as the completion of specific program modules.

.79 If, as discussed in paragraph .76 of this SOP, a software contract includes a discrete element that meets the segmentation criteria of SOP 81-1, the method chosen to measure progress-to-completion on the element should be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor should choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements.

.80 Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many companies use input measures because they are established more easily. As noted in paragraph 47 of SOP 81-1, "The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances." Further, paragraph 51 of SOP 81-1 states that

The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

.81 Input Measures. Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point does not indicate progress-to-completion.

.82 Costs incurred should be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, should not be included in the measurement of progress-to-completion.

.83 Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and often are established more easily than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve the customization of core software.

.84 If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user's site. For example, efforts to install, configure, and customize the software may occur at the vendor's site. The costs of such activities are measurable and recognizable at the time the activities are performed.

.85 Output Measures. Progress on arrangements that call for the production of identifiable units of output can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved,
thus providing a better approximation of progress than is provided by input measures, output measures may be somewhat unreliable because of the difficulties associated with establishing them.

.86 In order for the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they should not be used to measure progress-to-completion.

.87 If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer’s purpose in the customer’s environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it should be accounted for as core software.

.88 Value added by the customization of core software should be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module should be included in the measurement of progress-to-completion when that module is completed.

.89 Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer; project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

.90 Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable should be used to measure progress-to-completion only if such amounts indeed indicate such progress.

.91 The milestones that are selected to measure progress-to-completion should be part of the management review process. The percentage-of-completion designated for each milestone should be determined considering the experience of the vendor on similar projects.

.92 This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited.

13. **AICPA Statement of Position 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition** provides the following:

Conclusions

.05 The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2, which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph .03 of this SOP need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

.06 All other provisions of SOP 97-2, including the remainder of paragraph 10, should be applied as stated in SOP 97-2. Accordingly, this SOP does not alter the requirements that (a) any allocation of the fee in a multiple-element arrangement to the various elements should be based
on the fair values of each element, (b) those fair values must be supported by VSOE, and (c) in instances where there is insufficient VSOE of the fair values of each element to allow for an allocation of revenue to each element, all revenue from the arrangement should be deferred pursuant to paragraph 12 of that SOP.

Effective Date and Transition

.07 This SOP is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 and the related examples noted in paragraph .03 of this SOP.

14. **AICPA Statement of Position 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions** provides the following:

Conclusions

.06 The following changes are made to SOP 97-2.

a. The following sentence is added to the end of paragraph 11 of SOP 97-2.

Moreover, to the extent that a discount exists, the residual method described in paragraph 12 [of SOP 97-2] attributes that discount entirely to the delivered elements.

b. The following is added to the end of paragraph 12 of SOP 97-2.

There may be instances in which there is vendor-specific objective evidence of the fair values of all undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

c. The following example is added to appendix A of SOP 97-2, following "Multiple Element Arrangements—Products and Services—Example 3."

Multiple Element Arrangements—Products and Services—Example 4

Facts

A vendor sells software product A for $950. The license arrangement for product A always includes one year of "free" PCS. The annual renewal price of PCS is $150.

Revenue Recognition

Assuming that, apart from the lack of vendor-specific objective evidence of the fair value of the delivered software element, all applicable revenue recognition criteria in this SOP [SOP 97-2] are met, revenue in the amount of $150 should be deferred and recognized in income over the one-year PCS service period. Revenue of $800 should be allocated to the software element and recognized upon delivery of the software.

Discussion

Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific
objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph 12 of this SOP [SOP 97-2] states, however, that the residual method should be used when there is vendor-specific objective evidence of the fair values of all undelivered elements; all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.

If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs 12 and 58 [of SOP 97-2].

Paragraph 5 of SOP 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition, is replaced with the following.

The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph 3 of this SOP [SOP 98-4] need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

All provisions of SOP 97-2 for software transactions outside the scope of this SOP and all other provisions of SOP 97-2 for transactions within the scope of this SOP should be applied as stated in SOP 97-2.

Effective Date and Transition

The provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 are effective December 15, 1998. All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

EITF 00-3: Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware provides the following:

EITF 00-3 ISSUE

1. In connection with the licensing of software products, some vendors are offering arrangements in which end users of the software do not take possession of the software. Rather, the software application resides on the vendor's or a third party's hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line ("hosting").

2. Structurally, the form of those arrangements may be split into two elements-(a) the right to use software and (b) the hosting service. The arrangements may or may not include a license right to the software and the customer may or may not have an option to take delivery of the software.

3. SOP 97-2 establishes standards for recognition of revenue for licensing, selling, leasing, or otherwise marketing computer software. The scope of SOP 97-2 includes arrangements that provide for multiple deliverables (for example, software products and services), which are termed multiple elements. Under SOP 97-2, if an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence (VSOE) of fair value and recognized when certain criteria are met. One of the criteria for revenue recognition is that delivery has occurred. In addition, if a multiple-element arrangement includes both software and services, the portion of the fee allocable to the services is recognized separately as the services are performed, provided certain criteria are met.
4. The issues are:

Issue 1—Whether SOP 97-2 applies to arrangements that require the vendor to host the software.

Issue 2—Whether SOP 97-2 applies to arrangements in which the customer has an option to take delivery of the software. If so, when does delivery of the software occur and how does the vendor’s hosting obligation impact revenue recognition?

EITF 00-3 DISCUSSION

5. The Task Force reached a consensus that a software element covered by SOP 97-2 is only present in a hosting arrangement if the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty and it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. Therefore, SOP 97-2 only applies to hosting arrangements in which the customer has such an option. Arrangements that do not give the customer such an option are service contracts and are outside the scope of SOP 97-2. The Task Force observed that hosting arrangements that are service arrangements may include multiple elements that affect how revenue should be attributed.

6. The Task Force also reached a consensus that for those hosting arrangements in which the customer has the option, as described above, to take possession of the software, delivery of the software occurs when the customer has the ability to take immediate possession of the software. The Task Force observed that if the software element is within the scope of SOP 97-2, all of the SOP’s requirements for recognizing revenue, including VSOE of fair value and the requirement that the fee allocated to the software element not be subject to forfeiture, refund, or other concession, must be met in order to recognize revenue upon delivery for the portion of the fee allocated to the software element. The portion of the fee allocated to the hosting element should be recognized as the service is provided. The Task Force noted that hosting arrangements that are, pursuant to this Issue, within the scope of SOP 97-2 may also include other elements, such as specified or unspecified upgrade rights, in addition to the software product and the hosting service.

7. The Task Force observed that if the vendor sells, leases, or licenses software that is within the scope of SOP 97-2, then the development costs of such software should be accounted for in accordance with Statement 86. Conversely, if the vendor never sells, leases, or licenses the software in an arrangement within the scope of SOP 97-2, then the software is utilized in providing services and the development costs of the software should be accounted for in accordance with SOP 98-1. However, if during such software’s development or modification, the vendor develops a substantive plan to sell, lease, or otherwise market the software externally, the development costs of the software should be accounted for in accordance with Statement 86.

EITF 00-3 STATUS

8. No further EITF discussion is planned.

RELEVANT LITERATURE:

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Statement of Statutory Accounting Principles No. 5—Liabilities, Contingencies and Impairments of Assets*
- *Statement of Statutory Accounting Principles No. 17—Preoperating and Research and Development Costs*
- *Statement of Statutory Accounting Principles No. 22—Leases*
Generally Accepted Accounting Principles
- AICPA Statement of Position 97-2: Software Revenue Recognition
- AICPA Statement of Position 98-4: Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition
- AICPA Statement of Position 98-9: Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions
- EITF 00-3: Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware
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Statutory Issue Paper No. 112

Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs

STATUS
Finalized December 4, 2000

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. Current statutory accounting guidance for accounting for the costs of computer software developed or obtained for internal use and web site development costs is provided in Statement of Statutory Accounting Principles No. 16—Electronic Data Processing Equipment and Software (SSAP No. 16) and Statement of Statutory Accounting Principles No. 17—Preoperating and Research and Development Costs (SSAP No. 17). However, these SSAPs do not provide specific guidance on accounting for internal use software and web site development costs.

2. GAAP guidance for these issues is established in AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (SOP 98-1) and FASB Emerging Issue Task Force 00-2, Accounting for Web Site Development Costs (EITF 00-2). Current statutory guidance is similar to GAAP, except that these issues are not specifically addressed.

3. The purpose of this issue paper is to address SOP 98-1 and EITF 00-2 and establish statutory accounting principles that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

4. This issue paper adopts SOP 98-1 paragraphs 11 through 42 and paragraph 93 with certain modifications. This issue paper also adopts EITF 00-2 in its entirety.

5. The modifications to SOP 98-1 are as follows:

   a. Paragraph 11 states that the accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP. This issue paper expands upon that paragraph to require that such costs shall be expensed as incurred.

   b. Paragraph 32 is amended to require that entities who license internal-use computer software follow the operating lease provisions outlined in Statement of Statutory Accounting Principles No. 22—Leases (SSAP No. 22);

   c. Paragraph 36 is amended to require that entities follow the amortization guidelines as established in paragraph 9 of Statement of Statutory Accounting Principles No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements (SSAP No. 19);
d. Paragraph 37 is amended to require that capitalized operating system software shall be
depreciated for a period not to exceed three years. Capitalized nonoperating system
software shall be depreciated for a period not to exceed five years. This treatment is
consistent with the guidelines of SSAP No. 16 and Issue Paper No. 109—Depreciation of
Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data
Processing Equipment and Software (Issue Paper No. 109);

e. Paragraph 40 is amended to require that if during the development of internal-use
software, an entity decides to market the software to others, the entity shall immediately
expense any amounts previously capitalized;

f. Paragraph 41 is amended to require entities to follow the disclosure provisions outlined in
paragraph 5 of SSAP No. 16 and paragraph 4 of SSAP No. 17;

g. Paragraph 42 is amended to require an effective date of January 1, 2002; and

h. Any software costs capitalized in accordance with this issue paper shall be deemed
nonoperating system software costs. Nonoperating system software is a nonadmitted
asset in accordance with SSAP No. 16.

6. In accordance with the reporting entity’s capitalization policy, immaterial amounts of such costs
can be expensed when incurred.

Effective Date and Transition
7. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting
Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue
paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not
represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions
reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the
Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or
after January 1, 2002.

DISCUSSION:

8. The modifications to SOP 98-1 were made in order to maintain consistency with current statutory

a. Paragraph 11 states that the accounting for costs of reengineering activities, which often
are associated with new or upgraded software applications, is not included within the
scope of this SOP. This issue paper expands upon that paragraph to require that such
costs shall be expensed as incurred. This treatment is consistent with the GAAP
equivalent contained within Emerging Issues Task Force Issue No. 97-13, Accounting for
Costs Incurred in Connection with a Consulting Contract or an Internal Project That
Combines Business Process Reengineering and Information Technology Transformation.

b. Paragraph 32 states that even though FASB Statement No. 13, Accounting for Leases
(FAS 13), excludes licensing agreements from its scope, entities should analogize to that
Statement when determining the asset acquired in a software licensing arrangement. The
concepts outlined in FAS 13 are inconsistent with the provisions of SSAP. No. 22,
therefore paragraph 32 was amended to require that licensing agreements shall be treated
as operating leases;
c. Paragraph 36 was modified to remain consistent with the amortization guidelines contained within SSAP No. 19 paragraph 9;

d. Paragraph 37 was amended to remain consistent with the depreciable lives guidelines contained within SSAP No. 16 and the recently adopted Issue Paper No. 109;

e. Paragraph 40 requires that if, during the development of internal-use software, an entity decides to market the software to others, the entity should follow FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed (FAS No. 86). Amounts previously capitalized under this SOP should be evaluated at each balance sheet date in accordance with paragraph 10 of FAS No. 86. Capitalized software costs should be amortized in accordance with paragraph 8 of FAS No. 86. Both paragraphs 8 and 10 are rejected in SSAP No. 17 and therefore the most conservative measure is to expense such amounts immediately;

f. Paragraph 41 includes references to various different GAAP pronouncements for its disclosure requirements. This paragraph was modified as SSAP Nos. 16 and 17 already include the pertinent disclosure requirements;

g. Paragraph 42 indicates that SOP 98-1 is effective for financial statements for fiscal years beginning after December 15, 1998. The paragraph was modified to allow an effective date of January 1, 2002 so as to provide ample opportunity for statutory accounting user implementation; and

h. In order to remain consistent with the treatment of nonoperating system software, the nonadmission criteria outlined in paragraph 2 of SSAP No. 16 were included in this issue paper. In order to prevent the possible misclassification of nonoperating system software as operating software, the working group felt it was appropriately conservative to classify all software costs capitalized in accordance with this issue paper as nonoperating system software costs. The Glossary to the SSAPs defines operating and nonoperating system software as:

The operating system is a program or a series of programs controlling the data job and task management operations of a computer or a computer network through executive scheduling and monitoring. It increases the productivity of a computer installation by managing the allocation of all available computer resources including the control processing unit, main storage and input/output devices.

Nonoperating systems software such as language processors, library routines and debugging aides and other computer software are not considered operating system software.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting

9. In general, capitalization of software is provided for in SSAP No. 16. This issue paper provides more specific guidelines for capitalization of internal software and web site development costs. SSAP No. 16 renders the following instruction:

2. EDP equipment and software generally meet the definition of assets established in SSAP No. 4—Assets and Nonadmitted Assets. EDP equipment and operating system software are
admitted assets to the extent they conform to the requirements of this statement. Nonoperating system software are nonadmitted assets.

3. EDP equipment and software shall be depreciated for a period not to exceed three years using methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements.

4. The aggregate amount of admitted EDP equipment and operating system software (net of accumulated depreciation) shall be limited to three percent of the reporting entity's capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any EDP equipment and operating system software, net deferred tax assets and net positive goodwill.

Disclosures

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

6. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 5 above shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

8. EDP equipment and software capitalized prior to January 1, 2001 shall be depreciated over the shorter of its remaining useful life or three years.

Generally Accepted Accounting Principles

10. AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use provides the following:

   .1 Accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP.

Conclusions

Characteristics of Internal-Use Computer Software

.12 For purposes of this SOP, internal-use software is software having the following characteristics:

   a. The software is acquired, internally developed, or modified solely to meet the entity’s internal needs.
   b. During the software’s development or modification, no substantive plan exists or is being developed to market the software externally.
A substantive plan to market software externally could include the selection of a marketing channel or channels with identified promotional, delivery, billing, and support activities. To be considered a substantive plan under this SOP, implementation of the plan should be reasonably possible. Arrangements providing for the joint development of software for mutual internal use (for example, cost-sharing arrangements) are not substantive plans to market software for purposes of this SOP. Similarly, routine market feasibility studies are not substantive plans to market software for purposes of this SOP.

.13 An entity must meet both characteristics in paragraph .12 for software to be considered for internal use.

.14 An entity’s past practices related to selling software may help determine whether the software is for internal use or is subject to a plan to be marketed externally. For example, an entity in the business of selling computer software often both uses and sells its own software products. Such a past practice of both using and selling computer software creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

.15 Computer software to be sold, leased, or otherwise marketed includes software that is part of a product or process to be sold to a customer and should be accounted for under FASB Statement No. 86. For example, software designed for and embedded in a semiconductor chip is included in the scope of FASB Statement No. 86 because it is an integral part of the product. By contrast, software for internal use, though it may be used in developing a product, is not part of or included in the actual product or service sold. If software is used by the vendor in the production of the product or providing the service but the customer does not acquire the software or the future right to use it, the software is covered by this SOP. For example, for a communications company selling telephone services, software included in a telephone switch is part of the internal equipment used to deliver a service but is not part of the product or service actually being acquired or received by the customer.

.16 The Appendix [paragraph .93] provides examples of when computer software is and is not for internal use.

Stages of Computer Software Development

.17 The following table illustrates the various stages and related processes of computer software development.

<table>
<thead>
<tr>
<th>Preliminary Project Stage</th>
<th>Application Development Stage</th>
<th>Post-Implementation/Operation Stage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conceptual formulation of alternatives</td>
<td>Design of chosen path, including software configuration and software interfaces</td>
<td>Training</td>
</tr>
<tr>
<td>Evaluation of alternatives</td>
<td>Coding</td>
<td>Application maintenance</td>
</tr>
<tr>
<td>Determination of existence of needed technology</td>
<td>Installation of hardware</td>
<td></td>
</tr>
<tr>
<td>Final selection of alternatives</td>
<td>Testing, including parallel processing phase</td>
<td></td>
</tr>
</tbody>
</table>

The SOP recognizes that the development of internal-use computer software may not follow the order shown above. For example, coding and testing are often performed simultaneously. Regardless, for costs incurred subsequent to completion of the preliminary project stage, the SOP should be applied based on the nature of the costs incurred, not the timing of their incurrence. For
example, while some training may occur in the application development stage, it should be expensed as incurred as required in paragraphs .21 and .23.

Research and Development

.18 The following costs of internal-use computer software are included in research and development and should be accounted for in accordance with the provisions of FAS No. 2:
   a. Purchased or leased computer software used in research and development activities where the software does not have alternative future uses.
   b. All internally developed internal-use computer software (including software developed by third parties, for example, programmer consultants) if (1) the software is a pilot project (that is, software of a nature similar to a pilot plant as noted in paragraph 9(h) of FASB Statement No. 2) or (2) the software is used in a particular research and development project, regardless of whether the software has alternative future uses.

Capitalize or Expense

.19 Preliminary Project Stage. When a computer software project is in the preliminary project stage, entities will likely—
   a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system?
   b. Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.
   c. Invite vendors to perform demonstrations of how their software will fulfill an entity’s needs.
   d. Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software? Should the software run on a mainframe or a client server system?
   e. Determine that the technology needed to achieve performance requirements exists.
   f. Select a vendor if an entity chooses to obtain software.
   g. Select a consultant to assist in the development or installation of the software.

.20 Internal and external costs incurred during the preliminary project stage should be expensed as they are incurred.

.21 Application Development Stage. Internal and external costs incurred to develop internal-use computer software during the application development stage should be capitalized. Costs to develop or obtain software that allows for access or conversion of old data by new systems should also be capitalized. Training costs are not internal-use software development costs and, if incurred during this stage, should be expensed as incurred.

.22 The process of data conversion from old to new systems may include purging or cleansing of existing data, reconciliation or balancing of the old data and the data in the new system, creation of new/additional data, and conversion of old data to the new system. Data conversion often occurs during the application development stage. Data conversion costs, except as noted in paragraph .21, should be expensed as incurred.

.23 Post-Implementation/Operation Stage. Internal and external training costs and maintenance costs should be expensed as incurred.

.24 Upgrades and Enhancements. For purposes of this SOP, upgrades and enhancements are defined as modifications to existing internal-use software that result in additional functionality—that is, modifications to enable the software to perform tasks that it was previously incapable of
performing. Upgrades and enhancements normally require new software specifications and may also require a change to all or part of the existing software specifications. In order for costs of specified upgrades and enhancements to internal-use computer software to be capitalized in accordance with paragraphs .25 and .26, it must be probable that those expenditures will result in additional functionality.

.25 Internal costs incurred for upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

.26 External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. (If maintenance is combined with specified upgrades and enhancements in a single contract, the cost should be allocated between the elements as discussed in paragraph .33 and the maintenance costs should be expensed over the contract period.) However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.

.27 Capitalization of costs should begin when both of the following occur.
   a. Preliminary project stage is completed.
   b. Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable that the project will be completed and the software will be used to perform the function intended.

Examples of authorization include the execution of a contract with a third party to develop the software, approval of expenditures related to internal development, or a commitment to obtain the software from a third party.

.28 When it is no longer probable that the computer software project will be completed and placed in service, no further costs should be capitalized, and guidance in paragraphs .34 and .35 on impairment should be applied to existing balances.

.29 Capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed.

.30 New software development activities should trigger consideration of remaining useful lives of software that is to be replaced. When an entity replaces existing software with new software, unamortized costs of the old software should be expensed when the new software is ready for its intended use.

Capitalizable Costs

.31 Costs of computer software developed or obtained for internal use that should be capitalized include only the following:
   a. External direct costs of materials and services consumed in developing or obtaining internal-use computer software. Examples of those costs include but are not limited to fees paid to third parties for services provided to develop the software during the application development stage, costs incurred to obtain computer software from third parties, and travel expenses incurred by employees in their duties directly associated with developing software.
   b. Payroll and payroll-related costs (for example, costs of employee benefits) for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the
Examples of employee activities include but are not limited to coding and testing during the application development stage.

c. Interest costs incurred while developing internal-use computer software. Interest should be capitalized in accordance with the provisions of FASB Statement No. 34, Capitalization of Interest Cost.

General and administrative costs and overhead costs should not be capitalized as costs of internal-use software.

.32 Entities often license internal-use software from third parties. Though FASB Statement No. 13, Accounting for Leases, excludes licensing agreements from its scope, entities should analogize to that Statement when determining the asset acquired in a software licensing arrangement.

Multiple-Element Software Arrangements Included in Purchase Price

.33 Entities may purchase internal-use computer software from a third party. In some cases, the purchase price includes multiple elements, such as training for the software, maintenance fees for routine maintenance work to be performed by the third party, data conversion costs, reengineering costs, and rights to future upgrades and enhancements. Entities should allocate the cost among all individual elements. The allocation should be based on objective evidence of fair value of the elements in the contract, not necessarily separate prices stated within the contract for each element. Those elements included in the scope of this SOP should be accounted for in accordance with the provisions of this SOP.

Impairment

.34 Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. Paragraph 8 of FASB Statement No. 121 requires that assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. FASB Statement No. 121 guidance is applicable, for example, when one of the following occurs related to computer software being developed or currently in use:

a. Internal-use computer software is not expected to provide substantive service potential,
b. A significant change occurs in the extent or manner in which the software is used or is expected to be used,
c. A significant change is made or will be made to the software program,
d. Costs of developing or modifying internal-use computer software significantly exceed the amount originally expected to develop or modify the software.

.35 Paragraph 10 of FASB Statement No. 121 requires that “if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of [FASB Statement No. 121].” When it is no longer probable that computer software being developed will be completed and placed in service, the asset should be reported at the lower of the carrying amount or fair value, if any, less costs to sell. The rebuttable presumption is that such uncompleted software has a fair value of zero. Indications that the software may no longer be expected to be completed and placed in service include the following:

a. A lack of expenditures budgeted or incurred for the project
b. Programming difficulties that cannot be resolved on a timely basis
c. Significant cost overruns
d. Information has been obtained indicating that the costs of internally developed software will significantly exceed the cost of comparable third-party software or software products, so that management intends to obtain the third-party software or software products instead of completing the internally developed software
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs  

IP No. 112

e. Technologies are introduced in the marketplace, so that management intends to obtain the third-party software or software products instead of completing the internally developed software

f. Business segment or unit to which the software relates is unprofitable or has been or will be discontinued.

Amortization

.36 The costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software’s use.

.37 In determining and periodically reassessing the estimated useful life over which the costs incurred for internal-use computer software will be amortized, entities should consider the effects of obsolescence, technology, competition, and other economic factors. Entities should consider rapid changes that may be occurring in the development of software products, software operating systems, or computer hardware and whether management intends to replace any technologically inferior software or hardware. Given the history of rapid changes in technology, software often has had a relatively short useful life.

.38 For each module or component of a software project, amortization should begin when the computer software is ready for its intended use, regardless of whether the software will be placed in service in planned stages that may extend beyond a reporting period. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed. If the functionality of a module is entirely dependent on the completion of other modules, amortization of that module should begin when both that module and the other modules upon which it is functionally dependent are ready for their intended use.

Internal-Use Computer Software Marketed

.39 If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, such as commissions, software reproduction costs, warranty and service obligations, and installation costs, should be applied against the carrying amount of that software. No profit should be recognized until aggregate net proceeds from licenses and amortization have reduced the carrying amount of the software to zero. Subsequent proceeds should be recognized in revenue as earned.

.40 If, during the development of internal-use software, an entity decides to market the software to others, the entity should follow FASB Statement No. 86. Amounts previously capitalized under this SOP should be evaluated at each balance sheet date in accordance with paragraph 10 of FASB Statement No. 86. Capitalized software costs should be amortized in accordance with paragraph 8 of FASB Statement No. 86. A pattern of deciding to market internal-use software during its development creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

Disclosures

.41 This SOP does not require any new disclosures; disclosure should be made in accordance with existing authoritative literature, including Accounting Principles Board (APB) Opinion No. 12, Disclosure of Depreciable Assets and Depreciation; APB Opinion No. 22, Disclosure of Accounting Policies (for example, amortization methods); FASB Statement Nos. 2 and 121; and SOP 94-6, Disclosure of Certain Significant Risks and Uncertainties.
Effective Date and Transition

.42 This SOP is effective for financial statements for fiscal years beginning after December 15, 1998, and should be applied to internal-use computer software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of this SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued.

Appendix

.93 Examples Illustrating When Computer Software Is for Internal Use

1. A manufacturing entity purchases robots and customizes the software that the robots use to function. The robots are used in a manufacturing process that results in finished goods.
2. An entity develops software that helps it improve its cash management, which may allow the entity to earn more revenue.
3. An entity purchases or develops software to process payroll, accounts payable, and accounts receivable.
4. An entity purchases software related to the installation of an online system used to keep membership data.
5. A travel agency purchases a software system to price vacation packages and obtain airfares.
6. A bank develops software that allows a customer to withdraw cash, inquire about balances, make loan payments, and execute wire transfers.
7. A mortgage loan servicing entity develops or purchases computer software to enhance the speed of services provided to customers.
8. A telecommunications company develops software to run its switches that are necessary for various telephone services such as voice mail and call forwarding.
9. An entity is in the process of developing an accounts receivable system. The software specifications meet the company’s internal needs and the company did not have a marketing plan before or during the development of the software. In addition, the company has not sold any of its internal-use software in the past. Two years after completion of the project, the company decided to market the product to recoup some or all of its costs.
10. A broker-dealer entity develops a software database and charges for financial information distributed through the database.
11. An entity develops software to be used to create components of music videos (for example, the software used to blend and change the faces of models in music videos). The entity then sells the final music videos, which do not contain the software, to another entity.
12. An entity purchases software to computerize a manual catalog and then sells the manual catalog to the public.
13. A law firm develops an intranet research tool that allows firm members to locate and search the firm’s databases for information relevant to their cases. The system provides users with the ability to print cases, search for related topics, and annotate their personal copies of the database.

Examples Illustrating When Computer Software Is Not Internal Use

14. An entity sells software required to operate its products, such as robots, electronic game systems, video cassette recorders, automobiles, voice-mail systems, satellites, and cash registers.
15. A pharmaceutical company buys machines and writes all of the software that allows the machines to function. The pharmaceutical company then sells the machines, which help control the dispensation of medication to patients and help control inventory, to hospitals.
16. A semiconductor entity develops software embedded in a microcomputer chip used in automobile electronic systems.
17. An entity purchases software to computerize a manual catalog and then sells the computer version and the related software to the public.
18. A software company develops an operating system for sale and for internal use. Though the specifications of the software meet the company's internal needs, the company had a marketing plan before the project was complete. In addition, the company has a history of selling software that it also uses internally and the plan has a reasonable possibility of being implemented.

19. An entity is developing software for a point-of-sale system. The system is for internal use; however, a marketing plan is being developed concurrently with the software development. The plan has a reasonable possibility of being implemented.

20. A telecommunications entity purchases computer software to be used in research and development activities.

21. An entity incurs costs to develop computer software for another entity under a contract with that other entity.

11. EITF 00-2 provides the following:

EITF 00-2 ISSUE

1. Companies are incurring significant costs to develop Internet web sites. These companies may be "Internet" companies, traditional "brick and mortar" companies, or service companies. The web sites may be used to promote or advertise products or services, supplant manual processes or services, sell products (including software) or services, or to do a combination of all three. Further, due to rapid changes in technology, new uses for web sites are being developed. Diversity in practice exists in accounting for web site development costs. Some entities capitalize web site development costs, others expense such costs, and still others capitalize some of those costs and expense the rest.

2. The issue is how an entity should account for costs incurred to develop a web site.

EITF 00-2 DISCUSSION

3. The Task Force discussed the accounting for web site development costs and reached the following consensuses.

Costs Incurred in the Planning Stage

4. Planning stage activities are described in detail in Exhibit 00-2A. The Task Force reached a consensus that, regardless of whether the web site planning activities specifically relate to software, all costs incurred in the planning stage should be expensed as incurred.

Costs Incurred in the Web Site Application and Infrastructure Development Stage

5. As described in Exhibit 00-2A, the web site application and infrastructure development stage involves acquiring or developing hardware and software to operate the web site. The cost of hardware is outside the scope of this Issue. SOP 98-1 provides guidance for distinguishing between internal-use software and software to be sold, leased, or otherwise marketed. A key aspect of the definition of internal-use software is that it excludes software for which a plan exists or for which a plan is being developed to market the software externally. The Task Force reached a consensus that all costs relating to software used to operate a web site should be accounted for under SOP 98-1 unless a plan exists or is being developed to market the software externally, in which case the costs relating to the software should be accounted for pursuant to Statement 86. Fees incurred for web site hosting, which involve the payment of a specified, periodic fee to an Internet service provider in return for hosting the web site on its server(s) connected to the Internet, generally would be expensed over the period of benefit.
Costs Incurred to Develop Graphics

6. For purposes of this Issue, graphics involve the overall design of the web page (use of borders, background and text colors, fonts, frames, buttons, and so forth) that affect the "look and feel" of the web page and generally remain consistent regardless of changes made to the content. The Task Force reached a consensus that graphics are a component of software and that the costs of developing initial graphics should be accounted for pursuant to SOP 98-1 for internal-use software, and pursuant to Statement 86 for software marketed externally. Modifications to graphics after a web site is launched should be evaluated to determine whether the modifications represent maintenance or enhancements of the web site. The accounting for maintenance and enhancements is discussed in paragraph 8.

Costs Incurred to Develop Content

7. Content refers to information included on the web site, which may be textual or graphical in nature (although the specific graphics described in paragraph 6, above, are excluded from content). For example, articles, product photos, maps, and stock quotes and charts are all forms of content. Content may reside in separate databases that are integrated into (or accessed from) the web page with software, or it may be coded directly into the web pages. The Task Force observed that the accounting for web site content involves issues that also apply to other forms of content or information that are not unique to web sites. Accordingly, the Task Force concluded that the accounting for content should be addressed as a separate EITF Issue.

Costs Incurred in the Operating Stage

8. As described in Exhibit 00-2A, costs incurred during the operating stage include training, administration, maintenance, and other costs to operate an existing web site. The Task Force reached a consensus that the costs of operating a web site should not be accounted for differently from the costs of other operations; that is, those costs should be expensed as incurred. However, costs incurred in the operation stage that involve providing additional functions or features to the web site should be accounted for as, in effect, new software. That is, costs of upgrades and enhancements that add functionality should be expensed or capitalized based on the general model of SOP 98-1 (which requires certain costs relating to upgrades and enhancements to be capitalized if it is probable that they will result in added functionality) or, for software that is marketed, Statement 86 (which applies its software capitalization model to "product enhancements," which include improvements that extend the life or significantly improve the marketability of a product). The Task Force observed that the determination of whether a change to web site software results in (a) an upgrade or enhancement, if internal-use software, or (b) a product enhancement, if externally marketed software, is a matter of judgment based on the specific facts and circumstances. The Task Force also observed that SOP 98-1 indicates that entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements must expense such costs as incurred.

Transition

9. The consensuses in this Issue are effective for web site development costs incurred for fiscal quarters beginning after June 30, 2000 (including costs incurred for projects in process as of the beginning of the quarter of adoption of these consensuses). Earlier application is encouraged. The Task Force observed that an entity may elect to adopt the consensuses as a cumulative effect of a change in accounting principles in accordance with Opinion 20.

10. Exhibit 00-2A illustrates the application of the above-described consensuses to specific web site development costs.

EITF 00-2 STATUS

11. No further EITF discussion is planned.
EXHIBIT 00-2A
APPLICATION OF THE EITF CONSENSUSES ON ISSUE 00-2

<table>
<thead>
<tr>
<th>Planning Stage</th>
<th>Web Site Development Activity</th>
<th>Accounting Required by Issue 00-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Develop a business, project plan, or both. This may include identification of specific goals for the web site (for example, to provide information, supplant manual processes, conduct e-commerce, and so forth), a competitive analysis, identification of the target audience, creation of time and cost budgets, and estimates of the risks and benefits.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>b.</td>
<td>Determine the functionalities (for example, order placement, order and shipment tracking, search engine, e-mail, chat rooms, and so forth) of the web site.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>c.</td>
<td>Identify necessary hardware (for example, the server) and web applications. Web applications are the software needed for the web site's functionalities. Examples of web applications are search engines, interfaces with inventory or other back-end systems, as well as systems for registration and authentication of users, commerce, content management, usage analysis, and so forth.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>d.</td>
<td>Determine that the technology necessary to achieve desired functionalities exists. Factors might include, for example, target audience numbers, user traffic patterns, response time expectations, and security requirements.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>e.</td>
<td>Explore alternatives for achieving functionalities (for example, internal versus external resources, custom-developed versus licensed software, company-owned versus third-party-hosted applications and servers).</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>f.</td>
<td>Conceptually formulate and/or identify graphics and content (refer to &quot;Graphics and Content Development Stages&quot; for further discussion).</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>g.</td>
<td>Invite vendors to demonstrate how their web applications, hardware, or service will help achieve the web site's functionalities.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>h.</td>
<td>Select external vendors or consultants.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>i.</td>
<td>Identify internal resources for work on the web site design and development.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>j.</td>
<td>Identify software tools and packages required for development purposes.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>k.</td>
<td>Address legal considerations such as privacy, copyright, trademark, and compliance.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>Web Site Application and Infrastructure Development Stage</td>
<td>Accounting Required by Issue 00-2</td>
<td></td>
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<tr>
<td>--------------------------------------------------------</td>
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</tr>
<tr>
<td>Web Site Development Activity</td>
<td>The discussion of web site application and infrastructure development assumes that any software is developed for the entity's internal needs and no plan exists or is being developed to market the software externally (refer to paragraph 12 of SOP 98-1). Software for which a plan exists or is being developed to market the software externally is subject to Statement 86, and costs associated with the development of that software should be expensed until technological feasibility is established (refer to paragraph 4 of Statement 86).</td>
<td></td>
</tr>
<tr>
<td>a. Acquire or develop the software tools required for the development work (for example, HTML editor, software to convert existing data to HTML form, graphics software, multimedia software, and so forth).</td>
<td>Apply SOP 98-1. Costs incurred to purchase software tools, or costs incurred during the application development stage for internally developed tools, generally should be capitalized unless they are used in research and development and (1) do not have any alternative future uses or (2) are internally developed and represent a pilot project or are being used in a specific research and development project (see paragraph 18 of SOP 98-1).</td>
<td></td>
</tr>
<tr>
<td>b. Obtain and register an Internet domain name.</td>
<td>Generally, capitalize pursuant to paragraph 24 of APB 17.</td>
<td></td>
</tr>
<tr>
<td>c. Acquire or develop software necessary for general web site operations, including server operating system software, Internet server software, web browser software, and Internet protocol software.</td>
<td>Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.</td>
<td></td>
</tr>
<tr>
<td>d. Develop or acquire and customize code for web applications (for example, catalog software, search engines, order processing systems, sales tax calculation software, payment systems, shipment tracking applications or interfaces, e-mail software, and related security features).</td>
<td>Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.</td>
<td></td>
</tr>
<tr>
<td>e. Develop or acquire and customize database software and software to integrate distributed applications (for example, corporate databases and accounting systems) into web applications.</td>
<td>Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.</td>
<td></td>
</tr>
<tr>
<td>f. Develop HTML web pages or develop templates and write code to automatically create HTML pages.</td>
<td>Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.</td>
<td></td>
</tr>
<tr>
<td>g. Purchase the web and application server(s), Internet connection (bandwidth), routers, staging servers (where preliminary changes to the web site are made in a test environment), and production servers (accessible to customers using the web site). Alternatively, these services may be provided by a third party via a hosting arrangement.</td>
<td>Acquisitions of servers and related hardware infrastructure are outside the scope of this issue. Payments for hosting arrangements should be expensed over the period of benefit.</td>
<td></td>
</tr>
</tbody>
</table>
h. Install developed applications on the web server(s).

Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.

i. Create initial hypertext links to other web sites or to destinations within the web site. Depending on the site, links may be extensive or minimal.

Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.

j. Test the web site applications (for example, stress testing).

Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.

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### Graphics and Content Development Stages

<table>
<thead>
<tr>
<th>Web Site Development Activity</th>
<th>Accounting Required by Issue 00-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Create initial graphics for the web site. Graphics include the design or layout of each page (that is, the graphical user interface), color, images, and the overall &quot;look and feel&quot; and &quot;usability&quot; of the web site. Creation of graphics may involve coding of software, either directly or through the use of graphic software tools. The amount of coding depends on the complexity of the graphics.</td>
<td>Apply SOP 98-1. Initial graphics are part of the software and generally should be capitalized pursuant to paragraph 21 of SOP 98-1.</td>
</tr>
<tr>
<td>b. Create content or populate databases. Content may be created or acquired to populate databases or web pages. Content may be acquired from unrelated parties or may be internally developed.</td>
<td>To be addressed in a future EITF Issue.</td>
</tr>
<tr>
<td>c. Enter initial content into the web site. Content is text or graphical information (exclusive of graphics described in (a) above) on the web site which may include information on the entity, products offered, information sources that the user subscribes to, and so forth. Content may originate from databases that must be converted to HTML pages or databases that are linked to HTML pages through integration software. Content also may be coded directly into web pages.</td>
<td>Apply SOP 98-1. Paragraph 22 of SOP 98-1 specifies that &quot;data conversion costs&quot; should be expensed as incurred. Similarly, costs to input content into a web site generally should be expensed as incurred. Software used to integrate a database with a web site generally should be capitalized pursuant to paragraph 21 of SOP 98-1.</td>
</tr>
</tbody>
</table>

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### Operating Stage

<table>
<thead>
<tr>
<th>Web Site Development Activity</th>
<th>Accounting Required by Issue 00-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Train employees involved in support of the web site.</td>
<td>Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.</td>
</tr>
<tr>
<td>b. Register the web site with Internet search engines.</td>
<td>Expense as incurred. These expenditures represent advertising costs and are expensed as incurred pursuant to paragraph 26 of SOP 93-7.</td>
</tr>
<tr>
<td>c. Perform user administration activities.</td>
<td>Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.</td>
</tr>
<tr>
<td>d. Update site graphics (for updates of graphics related to major enhancements, refer to (h), below).</td>
<td>Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.</td>
</tr>
</tbody>
</table>
e. Perform regular backups. Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.


g. Verify that links are functioning properly and update existing links (that is, link management or maintenance). Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

h. Add additional functionalities or features. Apply SOP 98-1. Generally, capitalize if they meet the definition of "upgrades and enhancements" in paragraph 24 of SOP 98-1.

i. Perform routine security reviews of the web site and, if applicable, of the third-party host. Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.


RELEVANT LITERATURE:

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Statement of Statutory Accounting Principles No. 16—Electronic Data Processing Equipment and Software
- Statement of Statutory Accounting Principles No. 17—Preoperating and Research and Development Costs
- Statement of Statutory Accounting Principles No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements
- Statement of Statutory Accounting Principles No. 22—Leases
- Issue Paper No. 109—Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software

Generally Accepted Accounting Principles
- AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use
- EITF 00-2, Accounting for Web Site Development Costs
Statutory Issue Paper No. 113

Mezzanine Real Estate Loans

STATUS
Finalized June 11, 2001

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting guidelines of Mezzanine Real Estate Loans (MREL).

SUMMARY CONCLUSION

2. For statutory accounting purposes, a MREL shall be defined as a debt obligation that is not a security, which is secured by a pledge of equity interest in an entity that owns real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer) that:

   a. Either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer;

   b. Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

   c. Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations).

3. MREL’s meet the definition of assets as specified in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

4. Reporting entities holding MREL’s shall follow the accounting and disclosure requirements defined within SSAP No. 37—Mortgage Loans (SSAP No. 37).

5. In order for a MREL to qualify as an admitted asset, the MREL agreement (the agreement) shall:

   a. Require that each pledgor abstain from granting additional security interests in the equity interest pledged; and

   b. In addition to satisfaction of the requirements set forth in paragraphs c and d below, the MREL lender shall employ techniques to minimize the likelihood or impact of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower. These techniques may include (by way of example and not limitation) one or more of the following: (i) separateness covenants, (ii) cash management techniques, (iii) exceptions to the non-recourse provisions for damages arising out of the mezz borrower’s failure to comply with covenants prohibiting additional debt, transfers of the real estate, transfers of pledged interests, and violation of the single asset/single purpose covenants, (iv) full recourse liability in the event of a bankruptcy filing on the
part of the real estate owner and, if different, on the part of the mezz borrower, and (v) loan guaranties; and

The selection of techniques that are applied in the instance of any particular MREL to achieve said purposes requires an exercise of judgment by the MREL lender. The reasonableness of the techniques utilized in any particular MREL will be assessed in light of the credit characteristics of the MREL borrower, any guarantors and the underlying real estate at the time of origination. Utilizing this standard provides flexibility to the MREL lender and provides a basis for the regulator and auditor in analyzing the reasonableness of the judgment of the MREL lender; and

c. The real estate owner and, if different, the mezz borrower shall:

i. Hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower (if different), the equity interest in the real estate owner;

ii. Not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower (if different), holding an ownership interest in the real estate owner; and

iii. Not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower, if different).

d. At the time of the initial investment, the MREL lender shall corroborate that the sum of the first mortgage and the MREL does not exceed 100% of the value of the real estate as evidenced by a current appraisal. Acceptable appraisal methods are described in paragraph 11 of SSAP No. 40—Real Estate Investments.

e. The MREL lender shall report in Appendix A-001 to its annual statement the amount and percentages of its total admitted assets held in MREL and the largest three investments held in MREL except that such detail shall not be required for assets held in MREL totaling less than 2.5% of its total admitted assets.

Effective Date
6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date for years ending on or after December 31, 2001.

DISCUSSION
Definition of MREL
7. An MREL is a loan secured by a pledge of direct or indirect equity interests in an entity that owns real estate (the “real estate owner”). The real estate owner is typically the borrower under a mortgage loan secured by the same real estate. The MREL borrower (“mezz borrower”) may be the real estate owner or one or more of the holder(s) of the direct or indirect equity interest(s) in the real estate owner. As used herein, “direct equity interests” means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in the real estate owner, and “indirect equity interests” means the then issued and outstanding shares or units of partnership, membership or other
beneficial interests in a member, partner, shareholder or other holder of direct equity interests in the real estate owner. The following illustrates one typical MREL structure:

**Typical Sources and Market Characteristics of MRELs**

8. Significant portions of large real estate loans are now originated with the intent of securitizing the real estate mortgage loan. Mortgage loans targeted for securitization are typically subject to uniform underwriting and structuring requirements, including requirements that (a) the mortgage loan satisfy a loan to value ratio of 65% or less, (b) prohibit encumbrance of the real estate to secure additional debt, and (c) the borrower satisfy certain SPE (special purpose entity) requirements (as described below).

9. In many instances, the subject real estate project requires financing in excess of 65% of the value of the property. By utilizing a MREL, the real estate owner is able to obtain a low cost first mortgage loan and the mezz borrower is able to obtain additional project financing in the form of the MREL without jeopardizing the securitization of the first mortgage loan by subjecting the real estate to additional liens.

10. Like its securitized mortgage loan counterpart, MRELs typically have common underwriting and structuring characteristics. As noted above, MRELs are secured by a pledge of the mezz borrower’s equity interest in the real estate owner. Similar to securitized loan requirements, the documents evidencing the MREL require that (a) the mezz borrower abstain from granting additional security interests in its equity interest in the real estate owner, and (b) both the real estate owner and the mezz borrower be a special purpose, bankruptcy remote corporation, limited liability company or limited partnership (a “SPE”). In the case of a limited partnership SPE, the general partner of such SPE must in turn be a SPE (and if the real estate owner is a limited partnership, the general partnership interest is also pledged to secure the MREL). The SPE requirements are intended to protect both the mortgage lender and the MREL lender from the risks associated with bankruptcy filings and consolidation of claims relating to affiliated entities.2

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1 A “securitized” real estate loan is a loan combined with other loans secured by real estate for sale in the secondary market, typically in the form of a commercial mortgaged backed security.

2 In order to comply with typical SPE requirements, an entity must, among other things: (i) hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower, the equity interest in the real estate owner; (ii) not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower, the ownership of the real estate owner; (iii) not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower); and (iv) have at all times an independent director or member whose vote is required for, among other things, a voluntary bankruptcy filing.
MREL Lender Remedies

11. Should the mezz borrower default on its obligations under the MREL, the MREL lender has the right to assume ownership and control of the real estate owner by realizing upon its security interest in the equity interest in the real estate owner. Similar to foreclosure of a junior mortgage position, the goal of this remedy is to gain control over the ownership and operation of the real estate and thereby preserve both the good standing of the mortgage loan and the equity in the real estate that will ultimately repay the MREL.

12. Unlike foreclosure of a junior mortgage, the remedies afforded a MREL lender can typically be exercised very quickly and reach conclusion much faster than foreclosure; in most jurisdictions, a MREL lender can exercise remedies under the applicable Uniform Commercial Code (UCC) without the need for judicial action. Further, most MRELs are structured with cash management requirements that protect both the mortgage lender and the MREL lender from misapplication of rents and other income generated by the real estate. Finally, unlike most holders of junior mortgage liens, MREL lenders are typically able to negotiate notice and cure rights from the holders of the mortgage debt. These rights give the MREL lender the ability to preserve the good standing of the mortgage loan (thereby avoiding accrual of default interest and ultimately foreclosure) while the MREL lender exercises its remedies and gains control over the real estate, while remaining subordinate to the first mortgage obligation.

Remedy Comparison

13. Below is a description of several different forms of subordinated real estate investments, the security that the investment relies upon for repayment and the related default/foreclosure scenarios for each type of investment:

<table>
<thead>
<tr>
<th>Security</th>
<th>Default/Fore-Closure Remedy</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Mortgage</td>
<td>Become owner of property free and clear of all liens</td>
<td>If 1st mortgage not kept/brought current by 2nd then 1st may foreclose</td>
</tr>
<tr>
<td>Second Mortgage</td>
<td>Become owner of property subject to first mortgage</td>
<td>If 1st mortgage not kept/brought current by MREL Lender then 1st may foreclose</td>
</tr>
<tr>
<td>Mezzanine Real Estate Loan</td>
<td>Control owner of property subject to first mortgage</td>
<td></td>
</tr>
<tr>
<td>Comm. Mtg Back Security (AA &amp; Down)</td>
<td>Rights to subordinated cash flow from trust</td>
<td></td>
</tr>
</tbody>
</table>

14. As shown above, the downside credit outcome for a MREL is essentially the same as the outcome for a second mortgage. Both investment types rely on excess cash flow beyond the first mortgage for

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3 See Exhibit A for a detail question and answer with respect to the requirements of the UCC for MRELs.
payment, and in a default scenario both ultimately result in the lender controlling real property with a first mortgage in place that requires current payments.

15. Foreclosure of a second mortgage varies by state law (judicial vs. statutory) and for a MREL is generally the same in all states under the UCC. The MREL remedy process is typically quicker than the judicial process and is similar in time to states with a statutory foreclosure process.

16. MRELs are also documented with monthly payment requirements and hard maturity dates. Like loans secured by a second mortgage, MRELs’ typical return characteristics do not vary with the amount of cash flow available for payment. MRELs are passive investments, with no or very little authority over management of the real property prior to default, but similar to other debt instruments have protective covenants (rules), which, if violated, trigger the right to exercise the remedies discussed above.

17. MRELs meet the definition of assets as specified in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of SSAP No. 37 and this issue paper (particularly, paragraph 5). Recording MRELs as admitted assets is consistent with the recognition concept in the Statement of Concepts (i.e., the existence of readily marketable assets available when both current and future obligations are due). Due to their similarity to second mortgages, the requirement to account and disclose MRELs in accordance with SSAP No. 37 is concordant with the principle of consistency in the Statement of Concepts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
18. As MRELs are not currently defined or identified as admitted assets within the Accounting Practices and Procedures Manual, they are currently nonadmitted in accordance with SSAP No. 4.

19. The Invested Assets Working Group addressed the admissibility of MRELs at its August 28, 2000 working group meeting. The following represents an excerpt from a report containing its recommendation as to the admissibility of such assets:

In addition to reviewing the material you provided, the IAWG also heard a presentation (including recommendations) from Interested Persons on Mezzanine Loans. The IAWG agrees that Mezzanine Loans meet the definition of assets contained in SSAP No. 4—Assets and Nonadmitted Assets and should be admitted assets if they conform to the requirements of SSAP No. 37—Mortgage Loans. However, we also believe Mezzanine Loans should be treated as an entirely new type of asset class. Accordingly, the IAWG recommends that any proposed regulatory accounting guidance first precisely define a mezzanine loan by reference to its structural features and legal characteristics. For example, we understand that the borrower takes ownership rights in the entity owning the property. This legal interest is not the same thing as an interest in real estate secured by a mortgage lien. Therefore, it will be important to identify how the state Uniform Commercial Code will define an ownership interest and how an insurer investor perfects a security interest in ownership rights. Ownership rights in the entity may also subject the insurer to owner related liabilities that should be considered in accounting guidance. Further, to the extent the real estate is to play a significant role in recovering the value of the loan in a default situation, it is also important to understand how the insurer effectively ensures that the borrower cannot further encumber its real estate. In this regard, the IAWG noted that the written discussion paper presented by the Interested Persons did not provide an authoritative description of the structural or other characteristics of this type of asset. The IAWG also recommends that the Risk Based Capital Task Force should determine the appropriate Risk Based Capital treatment for Mezzanine Loans.

Generally Accepted Accounting Principles
RELEVANT LITERATURE

Statutory Accounting
– Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
– SSAP No. 4—Assets and Nonadmitted Assets
– SSAP No. 37—Mortgage Loans

Generally Accepted Accounting Principles
– FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
– FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
– FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan
– FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114
– FASB Emerging Issues Task Force Issue No. 84-19, Mortgage Loan Payment Modifications
– FASB Emerging Issues Task Force Issue 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations
– AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans
ISSUE PAPER 113 – EXHIBIT A

Uniform Commercial Code Questions and Answers

As further background on the treatment and structure of a mezzanine real estate loan, the following questions and answers are presented.

1. How is a security interest of this type characterized under the UCC?
   - Either investment property, general intangible or instrument
   - Security interest in shares of a corporation should be investment property. See § 9-102(a)(49); § 8-102(a)(15); § 8-103(a)
   - Partnership or limited liability company- generally a general intangible. See § 9-102(a)(42)
   - If such interests represented in writing could be classified as “instruments”. See § 9-102(47).
   - Require borrowers to opt into Article 8. See § 8-102(a)(15)(iii)(b) investment property.

2. How does the insurer perfect its security interest?
   - A security interest in investment property is perfected by either obtaining “control”, See § 9-314, or filing a financing statement. See § 9-312(a).
   - An interest that is perfected by control has priority over one perfected by filing. See § 9-328.
   - A secured party has control of investment property when the secured party may transfer that property without further consent from the owner. See § 8-106.
   - If the collateral is a certificated security in bearer form control is achieved by possession. See § 8-106(a).
   - If the collateral is a certificated security in registered form control is achieved when the secured party takes possession of the certificate and the certificate is endorsed to the party or is registered in the party’s name upon issue or transfer. See § 8-106(b). Certificated securities are accompanied by executed stock powers.
   - If the collateral is an uncertificated security control is achieved by “delivery” of the security, which can be achieved by the secured party becoming the registered owner, or the issuer providing that it will comply with instructions of the secured party without further action from the registered owner. See § 8-106(c). A pledge or security interest in uncertificated securities is typically acknowledged by the issuer delivering an “Initial Transaction Statement”. See § 8-408.
   - An interest in a general intangible is perfected by filing a financing statement. See § 9-310.
   - An interest in an instrument may be perfected by filing a financial statement, See § 9-312(a), or by possession. See § 9-313.
   - Security interest extends to all proceeds generated by the pledged securities. See § 9-306(1).
   - Typically, regardless of the nature of the securities pledged, the secured party will file UCC financing statements as a precautionary measure.

3. What steps does the insurer take to realize on the collateral?
   - Once the borrower is in default, the secured party may possess the collateral either through the judicial process or any other peaceful means. See § 9-610(b).
   - If the secured party has perfected by control it has the ability to foreclose on the collateral without additional steps. See § 9 - 601.
   - The UCC provides that disposition of collateral following default must be conducted in a commercially reasonable manner. See § 9-610(b).
4. Does the answer differ under the old UCC and the amended UCC, due to take effect in 2001?

- The most significant change relevant to these transactions is that a security interest in an instrument may now be perfected by filing; where the prior Article 9 allowed perfection of an instrument only by possession. See § 9-312(a).
- Where a subsequent purchaser is unaware of the secured party’s interest, the interest may be extinguished upon purchase. See § 9-330(d). This risk is minimized by the secured party obtaining an Initial Transaction Statement confirming registration of the pledge of uncertificated securities and by the secured party taking possession of certificated securities together with executed stock powers.
- The filing of a financing statement does not constitute notice. See § 9-331.

5. Could a fraudulent borrower further encumber the real estate and thus defeat the insurer’s interest in the real estate?

Yes, but some factors that mitigate the risk:

- Typically, a mezzanine loan will have a hard lockbox. Since no cash will flow to a subsequent encumbering lender, most mortgagees would be dissuaded from loaning funds with the security of a second mortgage.
- Until securitization sometimes second mortgage is required for just this reason.
- The Special Purpose Entity (SPE) organizational documents will prohibit such a mortgage. Any reputable lender will ask for opinion of counsel that the mortgage is authorized. Reputable counsel would obtain copies of the organizational documents before rendering an opinion and the lender might request such documents as well.
- Sometimes the secured lender is given special member status where its vote/consent is required for specified actions such as the grant of subordinate liens.
- Violation of the entity’s organizational documents would subject the grant of a subordinate mortgage to challenge as an ultra vires act.
- The securitized first mortgage will make the grant of additional liens on the property an event of default. No reputable mortgagee would lend money with the risk of an immediate default under the first mortgage. The risk of such a default might also deter the borrower from placing the mortgage on the property.
- The granting of an additional lien will likely trigger liability under the non-recourse carveouts under the first and mezzanine loan documents. Fraud is typically a carve-out from the non-recourse provisions of the documents and violation of the SPE covenants may also be a carve-out. There may be an express carveout for voluntary liens. Assuming the entity/individual guarantying the non-recourse carveouts (typically entities or individuals affiliated with both the mortgage borrower and the mezzanine borrower) has assets available to satisfy claims, the triggering of a significant non-recourse carveout liability is a substantial deterrent. Payments under the carveouts would also provide a source of repayment to the mezzanine lender.

6. Could a lender inherit borrower liabilities for say, environmental remediation?

Yes, but some factors that mitigate the risk:

- Mezzanine lenders typically require Phase I Environmental reports and further testing if the Phase I indicates a problem.
- Prior to foreclosing on the ownership interest in the property owner, the mezzanine lender would update its initial Phase I.
• It is common to obtain for the benefit of the Mezzanine Lender as well as the First Mortgagee an environmental indemnification. The value of this will depend upon the creditworthiness of the indemnifying party.
• The SPE covenants will limit the activities the entity may engage in which if honored would limit the obligations that a mezzanine lender would assume. Violation of the SPE covenants would trigger personal recourse liability in those situations when the SPE covenants are carve-outs to the non-recourse provisions.
• The lender protections against environmental liabilities in a first mortgage situation may be overrated since to sell the property with significant environmental problems is likely to result in significant loss. Most often the lender assesses the environmental liability and may elect to take title and cure the problem before selling. The mezzanine lender may similarly elect to take title and cure the problem if that makes economic sense.
• The mezzanine lender assumes ownership of stock/membership interest/partnership interests in a SPE that holds title to potentially contaminated real estate. By avoiding any action that would cause a court “to pierce the corporate veil” (a difficult standard for a plaintiff to overcome) the mezzanine lender’s sole exposure is its investment in the SPE. The Lender can be further insulated by transferring ownership of the real estate SPE to an SPE created by the mezzanine lender.

7. Are there similar types of structural risks introduced by this structure that should be part of the criteria for determining whether mortgage loan treatment is appropriate?

You have identified the three major risks:

• Certainty of ability to foreclose
• Possibility that junior mortgages or liens could encumber the property with no ability to foreclose out the mortgages or liens
• Liability for entity level obligations

There are some distinct advantages:

• A mezzanine lender can gain control over the property in say 30 days as compared to years in judicial foreclosure states.
• The lockbox structure, atypical in a classic second mortgage, prevents the borrower from milking the property and diverting cash.
• The SPE structure, atypical with second mortgages prior to the advent of securitized transactions, limits the activities of the borrower to the single mortgaged property making it less likely that other activities or properties adversely affect the mortgaged property.
• The Intercreditor Agreement with the First Mortgagee is likely to be more advantageous than any agreement reached by a second mortgagee. Cure rights can frequently be obtained.
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Statutory Issue Paper No. 114

Accounting for Derivative Instruments and Hedging Activities

STATUS
Finalized October 16, 2001

Type of Issue
Common Area

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principles No. 31—Derivative Instruments (SSAP No. 31) contains guidance on accounting for derivative instruments. The applicable GAAP guidance is included in Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133), FAS 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 an amendment of FASB Statement No. 133 (FAS 137), FAS 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133 (FAS 138) and their related Emerging Issues Task Force Issues.

2. The purpose of this issue paper is to address the concepts outlined in FAS 133 and establish a comprehensive statutory accounting model for derivative instruments. This issue paper will also reassess the provisions of SSAP No. 31. The result will be a new SSAP, which will supersede SSAP No. 31. The purpose also includes development of an accounting model for derivatives that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

3. SSAP No. 31 is superseded in its entirety by the conclusions outlined in this issue paper.

4. This issue paper addresses the recognition of derivatives and measurement of derivatives used in:
   a. Hedging transactions;
   b. Income generation transactions; and
   c. Replication transactions

Definitions (for purposes of this issue paper)

5. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:
   a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
   b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

6. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements or instruments substantially similar thereto or any series or combination thereof.
a. “Caps” are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;

b. “Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor;

c. “Floors” are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

d. “Forwards” are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;

e. “Futures” are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;

f. “Options” are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;

g. “Swaps” are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;

h. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

7. “Firm commitment” is an agreement with an unrelated party, binding on both parties and expected to be legally enforceable, with the following characteristics:
a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield;

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable; and

c. For investments in subsidiary, controlled, and affiliated entities (as defined by SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities) and investments in limited liability companies (as defined by SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies) it must be probable that acquisition will occur within a reasonable period of time.

8. A hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce:

a. The risk of a change in the fair value or cash flow of assets and liabilities which the reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence; or

b. The currency exchange rate risk or the degree of exposure as to assets and liabilities which a reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence.

9. “Income generation transaction” is defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

10. “Replication (Synthetic Asset) transaction” is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

11. “Forecasted transaction” is a transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

12. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

Embedded Derivative Instruments

13. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded
derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Impairment

14. This issue paper adopts the impairment guidelines established by SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5) for the underlying financial assets or liabilities.

Recognition and Measurement of Derivatives Used in Hedging Transactions

15. Derivative instruments represent rights or obligations that meet the definitions of assets (SSAP No. 4—Assets and Nonadmitted Assets) or liabilities (SSAP No. 5) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 8 through 10 of SSAP No. 27. Derivative instruments are admitted assets to the extent they conform to the requirements of this issue paper.

16. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet the criteria of an effective hedge shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

17. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective. Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

a. Any criterion in paragraphs 20 through 23 is no longer met;

b. The derivative expires or is sold, terminated, or exercised (impact recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 18);

c. The entity removes the designation of the hedge; or

d. The derivative is deemed to be impaired in accordance with paragraph 14. A permanent decline in a counterparty’s credit quality/rating is one example of impairment required by paragraph 14, for derivatives used in hedging transactions.

18. For those derivatives which qualify for hedge accounting, the change in the carrying value or cash flow of the derivative shall be recorded consistently with how the changes in the carrying value or cash flow of the hedged asset, liability, firm commitment or forecasted transaction are recorded.
Hedge Designations

19. An entity may designate a derivative instrument as hedging the exposure to:

   a. Changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk. This type of hedge can be utilized regardless of whether the hedged asset or liability is recorded in the financial statements at fair value;

   b. Variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction; or

   c. Foreign currency exposure. Specific examples include a fair value or cash flow hedge of a firm commitment or financial instrument.

Fair Value Hedges

20. Fair value hedges qualify for hedge accounting if all of the following criteria are met:

   a. At inception of the hedge, the formal documentation requirements of paragraph 26 are met;

   b. Both at inception of the hedge and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship;

   c. The term highly effective has the same meaning as the notion of high correlation as utilized in FAS No. 80, Accounting for Futures Contracts (FAS 80). As a result, highly effective describes a fair value hedging relationship where the change in the fair value of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the fair value of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibit A and B;

   d. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof); and

   e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.
Cash Flow Hedges

21. Cash flow hedges qualify for hedge accounting if all of the following criteria are met:

a. At inception of the hedge, the formal documentation requirements of paragraph 26 are met;

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship; and

c. The term highly effective has the same meaning as the notion of high correlation as utilized in FAS No. 80. As a result, highly effective describes a cash flow hedging relationship where the change in the cash flows of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the cash flows of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibit A and B.

Hedging Forecasted Transactions

22. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable. An assessment of the likelihood that a forecasted transaction will take place should not be based solely on management's intent because intent is not verifiable. The transaction's probability should be supported by observable facts and the attendant circumstances. Consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur:

i. The frequency of similar past transactions;

ii. The financial and operational ability of the entity to carry out the transaction;

iii. Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);

iv. The extent of loss or disruption of operations that could result if the transaction does not occur; and

v. The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering).

The term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not. In addition, both the length of time until a forecasted
transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that it is probable. For example, a transaction forecasted to occur in five years may be less likely than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt typically would be probable if supported by an existing contract. Additionally, other factors being equal, the greater the physical quantity or future value of a forecasted transaction, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be required to support an assertion that it is probable. For example, less evidence generally would be needed to support forecasted investments of $100,000 in a particular month than would be needed to support forecasted investments of $950,000 in that month by an entity, even if its investments have averaged $950,000 per month for the past 3 months.

A forecasted transaction that is expected to occur with 2 months of the original forecasted date (or time frame) may still be considered probable. If the transaction will not occur until greater than 2 months after the original forecasted date, it is no longer probable and will be accounted for as per the following paragraph.

If a forecasted transaction is determined to no longer be probable per the standards above, hedge accounting shall cease immediately and any deferred gains or losses on the derivative must be recognized in unrealized gains or losses. If an entity demonstrates a pattern of determining that hedged forecasted transactions probably will not occur, such action would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions. Accordingly, hedging of forecasted transactions will no longer be permitted by that entity.

(c) If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient.

d) If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its cash flows attributable to default or changes in the obligor’s creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge. Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must specifically be identified as part of the designation and documentation at the inception of the hedging relationship. An entity may not designate prepayment risk as the risk being hedged.
Foreign Currency Hedges

23. For foreign currency hedges, this issue paper adopts paragraphs 36 through 42 (except for last sentence of paragraph 38) of FAS No. 133 and paragraphs 4b. through 4o. of FAS No. 138 which amend FAS No. 133.

Hedge Effectiveness

24. The measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 26.

25. The gain or loss on a derivative designated as a cash flow hedge and assessed to be effective is reported consistently with the hedged item. If an entity’s defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in Exhibit B), that excluded component of the gain or loss shall be recognized as an unrealized gain or loss. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the changes in the option’s time value would be recognized in unrealized gains or losses. Time value is equal to the fair value of the option less its intrinsic value.

Documentation Guidance

26. At inception of the hedge, documentation must include:

   a. A formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness;

   b. An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 of FAS 133;

   c. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions; and

   d. A description of the reporting entity's methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.

27. For all derivatives terminated, expired, or exercised during the year:

   a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;

   b. A description, for each instrument, of the nature of the transaction, including:

      i. The date of the transaction;
ii. A complete and accurate description of the specific derivative, including
description of the underlying securities, currencies, rates, indices, commodities,
derivatives, or other financial market instruments;

iii. Number of contracts or notional amount;

iv. Date of maturity, expiry or settlement;

v. Strike price, rate or index (termination price for futures contracts);

vi. Counterparty, or exchange on which the transaction was traded; and

vii. Consideration paid or received, if any, on termination.

c. Description of the reporting entity's methodology to verify that derivatives were effective
hedges; and

d. Identification of any derivatives that ceased to be effective as hedges.

28. For derivatives open at quarter-end:

a. A description of the methodology used to verify the continued effectiveness of hedges;

b. An identification of any derivatives which have ceased to be effective as hedges;

c. A description of the reporting entity's methodology to determine fair values of
derivatives;

d. Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

General

29. Income generation transactions are defined as derivatives written or sold to generate additional
income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting
entity writes an equity call option on stock that it already owns).

30. Because these transactions require writing derivatives, they expose the reporting entity to
potential future liabilities for which the reporting entity receives a premium up front. Because of this risk,
dollar limitations and additional constraints are imposed requiring that the transactions be "covered" (i.e.,
offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the
derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity
in essence hedges the derivative risk.

31. As with derivatives in general, these instruments include a wide variety of terms regarding
maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

32. The principal features of income generation transactions are:

a. Premium received is initially recorded as a deferred liability;

b. The accounting of the covering asset or underlying interest controls the accounting of the
derivative. The covering asset/underlying interest is accounted at either fair value (e.g.,
common stocks) or (amortized) cost (e.g., bonds);

c. The gain/loss on termination of the derivative is a capital item. For life insurance
companies, it shall be subject to IMR treatment if interest rate related;

d. For options which are exercised, the remaining premium shall adjust the proceeds (cost)
associated with the exercise resulting in no explicit gain or loss reported for the derivative
itself.
33. The principal features of written fixed income covered call options are:

   a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract if the original duration is less than one year, otherwise carry at amortized cost;

   b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;

   c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;

   d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset shall be evaluated for write down or disclosure treatment in accordance with SSAP No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect unassigned funds (surplus) and income shall be considered.

34. Written fixed income covered call options shall be accounted for as follows:
<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT FAIR VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Open</strong></td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)</td>
<td>Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting.</td>
<td></td>
</tr>
<tr>
<td><strong>Closed – Expired</strong></td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable. (1)</td>
<td></td>
</tr>
<tr>
<td><strong>Closed – Exercised</strong></td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable. (1)</td>
<td></td>
</tr>
<tr>
<td><strong>Closed – Terminated</strong></td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable. (1)</td>
<td></td>
</tr>
</tbody>
</table>

**NOTE:**

(1) If premium is attached to covering asset, the accounting treatment for the covering asset applies.

**Written Covered Put Options**

35. The principal features of written covered put options are:
a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;
b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;
c. As with covered call writing, entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy.

36. Written covered put options shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>UNDERLYING INTEREST VALUED AT AMORTIZED COST</th>
<th>UNDERLYING INTEREST VALUED AT FAIR VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value.</td>
<td>Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>(Alternatively carry at consideration received if original duration is less than 1 year to maturity.)</td>
<td></td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust acquisition cost by premium received.</td>
<td>Adjust acquisition cost by premium received.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

Written Fixed Income Caps and Floors

37. The principal features of written fixed income caps and floors are:

a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the entity is selling off possible excess interest/income, the value of the covering asset is not relevant;
b. Gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

38. Written fixed income caps and floors shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)</td>
</tr>
<tr>
<td></td>
<td>Amortize over life of contract to produce constant yield.</td>
</tr>
<tr>
<td></td>
<td>Record any interest expense as “Other Investment Income” – negative value.</td>
</tr>
<tr>
<td>Closed – Matured</td>
<td>Would usually mature at zero amortized value.</td>
</tr>
<tr>
<td></td>
<td>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</td>
</tr>
<tr>
<td></td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Not applicable.</td>
</tr>
<tr>
<td></td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain/loss on termination to flow through IMR, if applicable.</td>
</tr>
<tr>
<td></td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
</tbody>
</table>

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

39. Replication (Synthetic Asset) transaction means a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

40. Any premium paid or received shall be carried as an asset or liability on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability). Premiums paid or received on the replication (synthetic asset) derivative should be amortized into investment income or expense until the exercise, termination or maturity date of the derivative.
41. If the replication (synthetic asset) transaction would be carried at amortized cost and the cash instrument used is carried at amortized cost, then the derivative used should be carried at amortized cost. The derivative may be valued at fair value when both the replication (synthetic asset) and the cash instrument are valued at amortized cost. This is consistent with the alternative valuation methods available for hedges. If the replication (synthetic asset) transaction would be carried at fair value and/or the cash instrument used is carried at fair value, then the derivative used should be carried at fair value.

<table>
<thead>
<tr>
<th></th>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>If the Replication (Synthetic Asset) is Valued at:</td>
<td>And Cash Instrument(s) Used is (are) Valued at:</td>
<td>The Derivative is Valued at:</td>
<td>Alternative Derivative Value Basis:</td>
</tr>
<tr>
<td>1</td>
<td>Amortized Cost</td>
<td>Amortized Cost</td>
<td>Amortized Cost</td>
<td>Fair value</td>
</tr>
<tr>
<td>2</td>
<td>Fair value</td>
<td>Fair value</td>
<td>Fair value</td>
<td>N/A</td>
</tr>
<tr>
<td>3</td>
<td>Amortized Cost</td>
<td>Fair value</td>
<td>Fair value</td>
<td>N/A</td>
</tr>
<tr>
<td>4</td>
<td>Fair value</td>
<td>Amortized Cost</td>
<td>Fair value</td>
<td>N/A</td>
</tr>
</tbody>
</table>

42. In the case of No. 3 in the chart above, the fair values for the cash instrument and derivative, when added together, shall not exceed the replication (synthetic asset) statement value. If this does occur, the excess shall reduce the fair value of the derivative.

43. If the replication (synthetic asset) transaction involves the exchange of interest related cash flows (default free assets), then the cash flows should be accrued as investment income. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The interest income portion should be accrued as investment income.

44. If the derivative is carried at fair value, the periodic change in the fair value should be recorded as an unrealized gain or loss adjustment to surplus until the transaction is terminated. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The fair value (equity) change should be recognized as a deferred asset/liability until the termination of the contract. Gains or losses on the derivative at termination or sale should be recognized as realized.

Disclosure Requirements

45. Reporting entities shall disclose the following for all derivative contracts used:

a. General disclosures:

i. A description of the reporting entity’s objectives for using derivatives, i.e., hedging, income generation or replication;

ii. A description of the context needed to understand those objectives and its strategies for achieving those objectives;

iii. The description for hedging objectives shall identify the category, e.g., fair value hedges, cash flow hedges, or foreign currency hedges, and for all objectives, the type of instrument(s) used;

iv. A description of the accounting policies for derivatives including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives used, and when recognized, where those instruments and related gains and losses are reported;
v. The net gain or loss recognized in unrealized gains or losses during the reporting period representing the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness; and

vi. The net gain or loss recognized in unrealized gains or losses during the reporting period resulting from derivatives that no longer qualify for hedge accounting.

b. Disclosures by type of instrument outstanding, e.g., call options, floors, etc.:

i. Notional or contract amounts;

ii. Carrying and fair values; and

iii. A discussion of the market risk, credit risk, and cash requirements of the derivatives.

c. For derivatives held for other than hedging purposes in addition to a and b above:

i. Average fair value of the derivatives during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;

ii. Net gains or losses detailed by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.

d. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

e. For derivatives accounted for as cash flow hedges of a forecasted transaction, disclose:

i. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments; and

iii. The amount of gains and losses classified in unrealized gains/losses related to cash flow hedges that have been discontinued because it was no longer probable that the original forecasted transactions would occur by the end of the originally specified time period or within 2 months of that date.

f. The disclosure requirements of 45 a, 45 b, and 45 c shall be included in the Annual Statement. Refer to the preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs 45 a through and 45 e shall be included in the annual audited statutory financial reports. Paragraph 55 of the Preamble states that disclosures made within specific schedules or exhibits to the Annual Statement need not be duplicated in a separate note.

Effective Date

46. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2002.
DISCUSSION

47. The purpose of this issue paper is two-fold. First, to provide a comprehensive source on accounting for derivatives used in hedges, income generation and replication transactions. Second, to address the GAAP guidance that has been issued subsequent to the finalization of SSAP No. 31. In general, this issue paper adopts the framework established by FAS No. 133 for fair value and cash flow hedges, but not its technical guidance (discussed further in subsequent paragraphs). This issue paper adopts the provisions of FAS No. 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be the hedged risk), this issue paper rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations (complete listing found in RELEVANT LITERATURE section of this issue paper). It should be noted that the conclusions reached in this issue paper are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this issue paper are intended to provide accounting guidance on the use of derivatives as allowed by an insurer’s state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer’s state of domicile does not allow under the state’s insurance regulatory requirements, e.g., in replication transactions.

Definitions

48. This issue paper defines a derivative instrument somewhat differently than FAS No. 133. The Statutory Accounting Principles (SAP) working group evaluated the FAS No. 133 definition and found that it was inconsistent with the manner in which derivatives are regulated in the insurance industry. While FAS 133 defines derivatives in the context of the characteristics contained in an instrument, the working group concluded that a definition based upon the legal form/contractual rights and obligations is more relevant to statutory reporting. As a result, the definition of a derivative in paragraph 5 of this issue paper is not intended to include life contracts, accident and health contracts, property and casualty contracts and deposit-type contracts as defined within SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force. Some of these contracts may be considered derivatives under the FAS No. 133 definition.

Embedded Derivative Instruments

49. FAS No. 133 requires that a contract containing an embedded derivative be accounted for separately from the host contract unless the embedded instrument is clearly and closely related to economic characteristics and risks of the host contract. This issue paper rejects that requirement and stipulates that such embedded derivatives shall not be accounted for separately from the host contract. The SAP working group does not believe this provision is applicable to insurance companies as evidenced by the FASB’s difficulty in providing guidance for certain life contracts that include features not associated with insured events. In addition, the SAP working group believes the insurance specific definition of a derivative used in paragraph 5 of this issue paper excludes a majority of the contracts that would include embedded derivatives.

Impairment

50. This issue paper adopts the impairment guidelines of SSAP No. 5. The application of such shall be consistent with the hedged or replicated asset. For instance, a derivative used in a hedging transaction would follow the impairment guidelines for the hedged asset, whereas a derivative used in a replication transaction would follow the impairment guidelines for the asset it is replicating. For derivatives used in hedging transactions one example of an impairment in accordance with SSAP No. 5 would be the permanent decline in the counterparty’s credit rating/quality. This example is not applicable to replication transactions as a reporting entity might be try to replicate a similar scenario.
Accounting for Derivative Instruments and Hedging Activities

Recognition and Measurement of Derivatives Used in Hedging Transactions

51. The SAP working group believes that a prudent use of derivatives can be an important tool in a sound risk management strategy. Risk management is the practice of defining the risk level an entity desires, identifying the risk level it currently has, and using derivative or other financial instruments to adjust the actual risk level to the desired risk level. Therefore, this issue paper allows holders of derivative instruments used in hedging transactions that meet the criteria of an effective hedge to value and report the derivative in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). This would allow derivatives that effectively hedge assets valued at amortized cost to also be valued at amortized cost.

52. This treatment is a dramatic departure from the requirements of FAS No. 133 in which all derivatives are valued and reported at fair value. This is possible for GAAP accounting because of the existence of FAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS No. 115) which requires a majority of GAAP (debt and equity) investments to be recorded at fair value. Therefore, the GAAP model is consistent within its framework to value many financial instruments at fair value. FAS No. 115 has been rejected by several SSAPs as regulators have concluded that the fluctuations of fair value from period to period violates the concepts of conservatism and consistency (further discussion can be found within Issue Paper Nos. 26, 30, 32 and 43). The result of rejecting FAS No. 115 results in a mixed valuation model in which certain financial instruments are valued at cost while some others are recognized at fair value (e.g., non-impaired bonds are recorded at amortized cost, equity instruments valued at fair value, real estate valued at cost or fair value depending upon management’s intent). The SAP working group does not believe it is appropriate to value all derivatives at fair value if the assets they are intended to hedge are not also recognized at fair value. Under the FAS No. 133 model, an insurer cannot utilize hedge accounting for debt securities that the entity has the positive intent and ability to hold to maturity as such securities are classified as held-to-maturity securities and reported at amortized cost. This is due to the fact that fluctuations in fair value of the derivative would not offset the fluctuations in fair value of the debt security as the debt security is recorded at amortized cost and there is no impact on surplus for changes in its fair value. By utilizing the concept of emulating valuation of the hedged assets and derivatives adopted in this issue paper consistency is achieved within the mixed valuation model. The concept of emulating valuation also supports the conservatism concept of statutory accounting in that using the amortized values and unrealized gains or losses, derivatives used in hedging should be protected from significant temporary gains from being incorporated into earnings. Further, the conservatism concept is supported in permanent losses by application of the impairment requirement.

53. This issue paper also adopts a provision to recognize the changes in fair value of a derivative that does not meet the criteria for hedge accounting to be recorded as unrealized gains or losses. SSAP No. 31 requires these changes to be recognized currently in earnings. The SAP working group believes the SSAP No. 31 treatment is inconsistent with similar guidance for equity investments in that the earnings process has not been completed.

Hedge Designations

54. This issue paper adopts the hedge designation framework established in FAS No. 133 in that entities may designate a derivative instrument as hedging the exposure to changes in fair value, variability in expected future cash flow or foreign currency exposures. This decision was made so that statutory accounting would be consistent for entities that must also conform to the documentation requirements of FAS No. 133.

55. This issue paper allows entities to hedge a portfolio of similar assets or similar liabilities but does not advocate hedging of an entire portfolio with dissimilar risks (referred to as macro hedging). If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the same risk exposure for which they are designated as being hedged. In a fair
value hedge, the change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.

56. To qualify for hedge accounting, this issue paper requires that fair value, cash flow and foreign currency hedges must be highly effective in achieving its offsetting objectives. The term “highly effective” is specifically defined within this issue paper unlike FAS No. 133. The SAP working group defined this term so that consistent application of effectiveness could be attained. Additionally, the issue paper rejects the FAS No. 133 concept of identifying and separately accounting for the effective and ineffective portions of a single hedge. This issue paper instructs entities not to bifurcate effectiveness; an entity either has an effective hedge (must use hedge accounting) or an ineffective hedge (must use fair value accounting). Again, deviation from FAS No. 133 was made for consistency.

57. The provisions of FAS No. 133 and 138 related to hedging foreign currency are adopted in this issue paper as they do not violate the principles that define the Statement of Concepts.

Documentation

58. This issue paper adopts documentation guidance, which is a combination of the requirements of FAS No. 133 and SSAP No. 31. None of the requirements of SSAP No. 31 were removed and the FAS No. 133 requirements were added so that entities that also complete GAAP statements would not have to maintain separate documentation.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

59. This issue paper retains the requirements of SSAP No. 31 for income generation transactions. This guidance is needed for those entities who wish to write or sell derivatives in an attempt to generate additional income and therefore do not use these types of derivatives to hedge risk exposures.

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

60. The guidance included for replication transactions was adopted as “NAIC Preferred Accounting Treatment” by the Emerging Accounting Issues working group on June 7, 1999. Inclusion in this issue paper of the preferred accounting guidance for replications formalizes its position within the Statutory Hierarchy.

Disclosures

61. This issue paper adopts disclosure requirements that represent a combination of the provisions of FAS No. 133 and SSAP No. 31.
Drafting Notes/Comments
- The issue of disclosing derivatives embedded within financial assets will be addressed by the Invested Asset (E) Working Group.
- The issue of accounting for and the reporting of insurance derivatives (used in hedging insurance exposures) will be addressed by the Insurance Securitization (E) Working Group.
- The general reference to FAS No. 133 and 138 for foreign currency hedges will be replaced with the specific language in the SSAP once the staff has an opportunity to meld the two pronouncements together.
- The reporting guidance referred to in paragraph 18 will be refined by the FAS No. 133 Subgroup after further deliberation.
- The language specific to Insurance Futures and Insurance Futures Options has not been included in this issue paper due to the lack of activity in this market.

RELEVANT STATUTORY AND GAAP GUIDANCE:

Statutory Accounting
62. Statement of Statutory Accounting Principles No. 31—Derivative Instruments provides the current statutory guidance for most derivative transactions.

63. The Emerging Accounting Issues Working Group adopted as NAIC preferred accounting treatment the conclusions reached in this issue paper for replication transactions. The following was taken from the June 7, 1999, minutes of the Working Group:

Mr. Clark reported that the working group had reached a tentative consensus on the issue of accounting for replication transactions during an interim conference call on May 12, 1999. This consensus was exposed on the NAIC website after the 1999 Spring National Meeting, and the NAIC staff received no comments on it.

Mr. Medley questioned whether the word “consideration” could be used instead of “premium” as shown on Attachment A Part (b) (see attachment 4 to the 5/12/99 conference call minutes). Maria Avila (Northwestern Mutual Life), on behalf of interested parties, indicated that the change would not modify the intent or conclusion of the proposal. Mr. Johnson made a motion to finalize the tentative consensus, as modified, and grant the proposal preferred NAIC accounting treatment. Mr. Ford seconded the motion. The working group unanimously adopted the motion.

Mr. Clark stressed that this issue falls under the old working group rules and, thus, the working group can only grant preferred NAIC accounting treatment. This issue will also be addressed by the Codification of Statutory Accounting Principles working group when SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities is reviewed under the maintenance process.

Generally Accepted Accounting Principles
64. FAS 133 provides the following guidance (the language shown in italics has been amended by FAS No. 137 and 138):

INTRODUCTION
1. This Statement addresses the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities.

2. Prior to this Statement, hedging activities related to changes in foreign exchange rates were addressed in FASB Statement No. 52, Foreign Currency Translation. FASB Statement No. 80, Accounting for Futures Contracts, addressed the use of futures contracts in other hedging activities. Those Statements addressed only certain derivative instruments and differed in the criteria required for hedge accounting. In addition, the Emerging Issues Task Force (EITF) addressed the accounting for various hedging activities in a number of issues.
3. In developing the standards in this Statement, the Board concluded that the following four fundamental decisions should serve as cornerstones underlying those standards:

   a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.
   
   b. Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (that is, gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.
   
   c. Only items that are assets or liabilities should be reported as such in financial statements.
   
   d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.

Those fundamental decisions are discussed individually in paragraphs 217–231 of Appendix C.

4. This Statement standardizes the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, by requiring that an entity recognize those items as assets or liabilities in the statement of financial position and measure them at fair value. If certain conditions are met, an entity may elect to designate a derivative instrument as follows:

   a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk (referred to as a fair value hedge)
   
   b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)
   
   c. A hedge of the foreign currency exposure of (1) an unrecognized firm commitment (a foreign currency fair value hedge), (2) an available-for-sale security (a foreign currency fair value hedge), (3) a forecasted transaction (a foreign currency cash flow hedge), or (4) a net investment in a foreign operation.

This Statement generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of (a) the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk or (b) the earnings effect of the hedged forecasted transaction. Appendix A provides guidance on identifying derivative instruments subject to the scope of this Statement and on assessing hedge effectiveness and is an integral part of the standards provided in this Statement. Appendix B contains examples that illustrate application of this Statement. Appendix C contains background information and the basis for the Board’s conclusions. Appendix D lists the accounting pronouncements superseded or amended by this Statement. Appendix E provides a diagram for determining whether a contract is a freestanding derivative subject to the scope of this Statement.

Scope and Definition

5. This Statement applies to all entities. Some entities, such as not-for-profit organizations and defined benefit pension plans, do not report earnings as a separate caption in a statement of financial performance. The application of this Statement to those entities is set forth in paragraph 43.

Derivative Instruments

6. A derivative instrument is a financial instrument or other contract with all three of the following characteristics:
a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

7. Underlying, notional amount, and payment provision. An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

8. Initial net investment. Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying.

9. Net settlement. A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:

a. Neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.

b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

Derivative instruments embedded in other contracts are addressed in paragraphs 12–16.

10. Notwithstanding the conditions in paragraphs 6–9, the following contracts are not subject to the requirements of this Statement:
a. “Regular-way” security trades. Regular-way security trades are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)). They provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed.

b. Normal purchases and normal sales. Normal purchases and normal sales are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)). They provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.

c. Certain insurance contracts. Generally, contracts of the type that are within the scope of FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, and No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:

(1) Traditional life insurance contracts. The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.

(2) Traditional property and casualty contracts. The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

However, insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises combine derivative instruments, as defined in this Statement, with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12.

d. Certain financial guarantee contracts. Financial guarantee contracts are not subject to this Statement if they provide for payments to be made only to reimburse the guaranteed party for a loss incurred because the debtor fails to pay when payment is due, which is an identifiable insurable event. In contrast, financial guarantee contracts are subject to this Statement if they provide for payments to be made in response to changes in an underlying (for example, a decrease in a specified debtor's creditworthiness).

e. Certain contracts that are not traded on an exchange. Contracts that are not exchange-traded are not subject to the requirements of this Statement if the underlying on which the settlement is based is one of the following:

(1) A climatic or geological variable or other physical variable

(2) The price or value of (a) a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash or (b) a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash
Specified volumes of sales or service revenues of one of the parties to the contract.

If a contract has more than one underlying and some, but not all, of them qualify for one of the exceptions in paragraphs 10(e)(1), 10(e)(2), and 10(e)(3), the application of this Statement to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Statement if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for an exception.

f. Derivatives that serve as impediments to sales accounting. A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Statement. For example, the existence of a guarantee of the residual value of a leased asset by the lessor may be an impediment to treating a contract as a sales-type lease, in which case the contract would be treated by the lessor as an operating lease. Another example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

11. Notwithstanding the conditions of paragraphs 6–10, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Statement:

   a. Contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders’ equity in its statement of financial position
   b. Contracts issued by the entity in connection with stock-based compensation arrangements addressed in FASB Statement No. 123, Accounting for Stock-Based Compensation
   c. Contracts issued by the entity as contingent consideration from a business combination. The accounting for contingent consideration issued in a business combination is addressed in APB Opinion No. 16, Business Combinations. In applying this paragraph, the issuer is considered to be the entity that is accounting for the combination using the purchase method.

In contrast, the above exceptions do not apply to the counterparty in those contracts. In addition, a contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock can be a derivative instrument for the issuer under paragraphs 6–10, in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Statement.

Embedded Derivative Instruments

12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:

   a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of
the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.

b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

13. For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

   a. The hybrid instrument can contractually be settled in a such a way that the investor (holder) would not recover substantially all of its initial recorded investment.

   b. The embedded derivative could at least double the investor’s initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Even though the above conditions focus on the investor’s rate of return and the investor’s recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in this paragraph at different points in time.

14. However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided they (a) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately as a derivative pursuant to the provisions of paragraphs 12 and 13 and (b) do not incorporate any terms not present in the original financial instrument described above.

15. An embedded foreign currency derivative instrument shall not be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the currency of the primary economic environment in which any substantial party to that contract operates (that is, its functional currency) or (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions). Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.
16. In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6–11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement.

Recognition of Derivatives and Measurement of Derivatives and Hedged Items
17. An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivative instruments shall be measured at fair value. The guidance in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, as amended, shall apply in determining the fair value of a financial instrument (derivative or hedged item). If expected future cash flows are used to estimate fair value, those expected cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or the timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

18. The accounting for changes in the fair value (that is, gains or losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Either all or a proportion of a derivative may be designated as the hedging instrument. The proportion must be expressed as a percentage of the entire derivative so that the profile of risk exposures in the hedging portion of the derivative is the same as that in the entire derivative. (Thus, an entity is prohibited from separating a compound derivative into components representing different risks and designating any such component as the hedging instrument, except as permitted at the date of initial application by the transition provisions in paragraph 49.) Subsequent references in this Statement to a derivative as a hedging instrument include the use of only a proportion of a derivative as a hedging instrument. Two or more derivatives, or proportions thereof, may also be viewed in combination and jointly designated as the hedging instrument. Gains and losses on derivative instruments are accounted for as follows:

a. No hedging designation. The gain or loss on a derivative instrument not designated as a hedging instrument shall be recognized currently in earnings.

b. Fair value hedge. The gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk shall be recognized currently in earnings in the same accounting period, as provided in paragraphs 22 and 23.

c. Cash flow hedge. The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraphs 30 and 31. The remaining gain or loss on the derivative instrument, if any, shall be recognized currently in earnings, as provided in paragraph 30.

d. Foreign currency hedge. The gain or loss on a derivative instrument or nonderivative financial instrument designated and qualifying as a foreign currency hedging instrument shall be accounted for as follows:

(1) The gain or loss on the hedging derivative or nonderivative instrument in
  a hedge of a foreign-currency-denominated firm commitment and the
offsetting loss or gain on the hedged firm commitment shall be recognized currently in earnings in the same accounting period, as provided in paragraph 37.

(2) The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale security and the offsetting loss or gain on the hedged available-for-sale security shall be recognized currently in earnings in the same accounting period, as provided in paragraph 38.

(3) The effective portion of the gain or loss on the hedging derivative instrument in a hedge of a forecasted foreign-currency-denominated transaction shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraph 41. The remaining gain or loss on the hedging instrument shall be recognized currently in earnings.

(4) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a net investment in a foreign operation shall be reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment to the extent it is effective as a hedge, as provided in paragraph 42.

19. In this Statement, the change in the fair value of an entire financial asset or liability for a period refers to the difference between its fair value at the beginning of the period (or acquisition date) and the end of the period adjusted to exclude (a) changes in fair value due to the passage of time and (b) changes in fair value related to any payments received or made, such as in partially recovering the asset or partially settling the liability.

Fair Value Hedges
General

20. An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof ("hedged item") that is attributable to a particular risk. Designated hedging instruments and hedged items qualify for fair value hedge accounting if all of the following criteria and those in paragraph 21 are met:

a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

   (1) For a fair value hedge of a firm commitment, the entity’s formal documentation at the inception of the hedge must include a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment.

   (2) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, the increases (or decreases) in the fair value of the
hedging instrument must be expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship (in accordance with paragraph 20(a) above).

c. If a written option is designated as hedging a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable change in the fair value of the combined instruments as exposure to losses from an unfavorable change in their combined fair value. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage.

(1) A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. (Thus, a collar can be designated as a hedging instrument in a fair value hedge without regard to the test in paragraph 20(c) unless a net premium is received.) Furthermore, a derivative instrument that results from combining a written option and any other nonoption derivative shall be considered a written option.

A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument, except as provided in paragraphs 37 and 42 of this Statement.

The Hedged Item

21. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:

a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).

(1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.

(2) If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following:
(a) A percentage of the entire asset or liability (or of the entire portfolio)
(b) One or more selected contractual cash flows (such as the portion of the asset or liability representing the present value of the interest payments in the first two years of a four-year debt instrument)
(c) A put option, a call option, an interest rate cap, or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 12 of this Statement
(d) The residual value in a lessor’s net investment in a direct financing or sales-type lease.

If the entire asset or liability is an instrument with variable cash flows, the hedged item cannot be deemed to be an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows.

b. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit organization, as discussed in paragraph 43.

c. The hedged item is not (1) an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings (for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings), (2) an investment accounted for by the equity method in accordance with the requirements of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, (3) a minority interest in one or more consolidated subsidiaries, (4) an equity investment in a consolidated subsidiary, (5) a firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a minority interest, or an equity method investee, or (6) an equity instrument issued by the entity and classified in stockholders’ equity in the statement of financial position.

d. If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, the designated risk being hedged is the risk of changes in its fair value attributable to changes in the obligor’s creditworthiness or if the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. (The designated hedged risk for a held-to-maturity security may not be the risk of changes in its fair value attributable to changes in market interest rates or foreign exchange rates. If the hedged item is other than an option component that permits its prepayment, the designated hedged risk also may not be the risk of changes in its overall fair value.)

e. If the hedged item is a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components), the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). That is, the price risk of a similar asset in a different location or of a major ingredient may not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline.

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the
designated risk being hedged is (1) the risk of changes in the overall fair value of
the entire hedged item, (2) the risk of changes in its fair value attributable to
changes in market interest rates, (3) the risk of changes in its fair value
attributable to changes in the related foreign currency exchange rates (refer to
paragraphs 37 and 38), or (4) the risk of changes in its fair value attributable to
changes in the obligor’s creditworthiness. If the risk designated as being hedged
is not the risk in paragraph 21(f)(1) above, two or more of the other risks (market
interest rate risk, foreign currency exchange risk, and credit risk) may
simultaneously be designated as being hedged. An entity may not simply
designate prepayment risk as the risk being hedged for a financial asset.
However, it can designate the option component of a prepayable instrument as
the hedged item in a fair value hedge of the entity’s exposure to changes in the
fair value of that “prepayment” option, perhaps thereby achieving the objective of
its desire to hedge prepayment risk. The effect of an embedded derivative of the
same risk class must be considered in designating a hedge of an individual risk.
For example, the effect of an embedded prepayment option must be considered
in designating a hedge of market interest rate risk.

22. Gains and losses on a qualifying fair value hedge shall be accounted for as follows:

a. The gain or loss on the hedging instrument shall be recognized currently in
   earnings.

b. The gain or loss (that is, the change in fair value) on the hedged item attributable
to the hedged risk shall adjust the carrying amount of the hedged item and be
   recognized currently in earnings.

If the fair value hedge is fully effective, the gain or loss on the hedging instrument, adjusted for
the component, if any, of that gain or loss that is excluded from the assessment of effectiveness
under the entity’s defined risk management strategy for that particular hedging relationship (as
discussed in paragraph 63 in Section 2 of Appendix A), would exactly offset the loss or gain on
the hedged item attributable to the hedged risk. Any difference that does arise would be the
effect of hedge ineffectiveness, which consequently is recognized currently in earnings. The
measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent
with the entity’s risk management strategy and the method of assessing hedge effectiveness that
was documented at the inception of the hedging relationship, as discussed in paragraph 20(a).
Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent
to which exact offset is not achieved. Although a hedging relationship must comply with an
entity’s established policy range of what is considered “highly effective” pursuant to paragraph
20(b) in order for that relationship to qualify for hedge accounting, that compliance does not
assure zero ineffectiveness. Section 2 of Appendix A illustrates assessing hedge effectiveness
and measuring hedge ineffectiveness. Any hedge ineffectiveness directly affects earnings
because there will be no offsetting adjustment of a hedged item’s carrying amount for the
ineffective aspect of the gain or loss on the related hedging instrument.

23. If a hedged item is otherwise measured at fair value with changes in fair value reported in
other comprehensive income (such as an available-for-sale security), the adjustment of the
hedged item’s carrying amount discussed in paragraph 22 shall be recognized in earnings rather
than in other comprehensive income in order to offset the gain or loss on the hedging instrument.

24. The adjustment of the carrying amount of a hedged asset or liability required by
paragraph 22 shall be accounted for in the same manner as other components of the carrying
amount of that asset or liability. For example, an adjustment of the carrying amount of a hedged
asset held for sale (such as inventory) would remain part of the carrying amount of that asset
until the asset is sold, at which point the entire carrying amount of the hedged asset would be
recognized as the cost of the item sold in determining earnings. An adjustment of the carrying
amount of a hedged interest-bearing financial instrument shall be amortized to earnings;
amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

25. An entity shall discontinue prospectively the accounting specified in paragraphs 22 and 23 for an existing hedge if any one of the following occurs:

a. Any criterion in paragraphs 20 and 21 is no longer met.
b. The derivative expires or is sold, terminated, or exercised.
c. The entity removes the designation of the fair value hedge.

In those circumstances, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 25(a) and 25(c) above, a different hedged item or a hedged transaction if the hedging relationship meets the criteria specified in paragraphs 20 and 21 for a fair value hedge or paragraphs 28 and 29 for a cash flow hedge.

26. In general, if a periodic assessment indicates noncompliance with the effectiveness criterion in paragraph 20(b), an entity shall not recognize the adjustment of the carrying amount of the hedged item described in paragraphs 22 and 23 after the last date on which compliance with the effectiveness criterion was established. However, if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion can be identified, the entity shall recognize in earnings the changes in the hedged item's fair value attributable to the risk being hedged that occurred prior to that event or change in circumstances. If a fair value hedge of a firm commitment is discontinued because the hedged item no longer meets the definition of a firm commitment, the entity shall derecognize any asset or liability previously recognized pursuant to paragraph 22 (as a result of an adjustment to the carrying amount for the firm commitment) and recognize a corresponding loss or gain currently in earnings.

Impairment

27. An asset or liability that has been designated as being hedged and accounted for pursuant to paragraphs 22–24 remains subject to the applicable requirements in generally accepted accounting principles for assessing impairment for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 22 of this Statement. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment requirements to the hedged asset or liability.

Cash Flow Hedges

General

28. An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale). Designated hedging instruments and hedged items or transactions qualify for cash flow hedge accounting if all of the following criteria and those in paragraph 29 are met:

a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in hedging the exposure to the hedged transaction’s variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.
(1) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

(2) Documentation shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or liability involved (if any), and the expected currency amount or quantity of the forecasted transaction.

(a) The phrase expected currency amount refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.

(b) The phrase expected quantity refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases during a period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28(b) for offsetting cash flows.

The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Thus, the forecasted transaction could be identified as the sale of either the first 15,000 units of a specific product sold during a specified 3-month period or the first 5,000 units of a specific product sold in each of 3 specific months, but it could not be identified as the sale of the last 15,000 units of that product sold during a 3-month period (because the last 15,000 units cannot be identified when they occur, but only when the period has ended).

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument, such as an at-the-money option contract, provides only one-sided offset against the hedged risk, the cash inflows (outflows) from the hedging instrument must be expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

c. If a written option is designated as hedging the variability in cash flows for a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage. (Refer to paragraph 20(c)(1).)

d. If a hedging instrument is used to modify the interest receipts or payments associated with a recognized financial asset or liability from one variable rate to another variable rate, the hedging instrument must be a link between an existing designated asset (or group of similar assets) with variable cash flows and an existing designated liability (or group of similar liabilities) with variable cash flows and be highly effective at achieving offsetting cash flows. A link exists if the basis (that is, the rate index on which the interest rate is based) of one leg of an interest rate swap is the same as the basis of the interest receipts for the
designated asset and the basis of the other leg of the swap is the same as the basis of the interest payments for the designated liability. In this situation, the criterion in the first sentence in paragraph 29(a) is applied separately to the designated asset and the designated liability.

A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument for a cash flow hedge.

The Hedged Forecasted Transaction

29. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable.

c. The forecasted transaction is a transaction with a party external to the reporting entity (except as permitted by paragraph 40) and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings (for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings). However, forecasted sales on credit and the forecasted accrual of royalties on probable future sales by third-party licensees are not considered the forecasted acquisition of a receivable. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.

e. If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Statement 115, the risk being hedged is the risk of changes in its cash flows attributable to default or changes in the obligor’s creditworthiness. For those variable cash flows, the risk being hedged cannot be the risk of changes in its cash flows attributable to changes in market interest rates.

f. The forecasted transaction does not involve a business combination subject to the provisions of Opinion 16 and is not a transaction (such as a forecasted purchase, sale, or dividend) involving (1) a parent company’s interests in consolidated subsidiaries, (2) a minority interest in a consolidated subsidiary, (3) an equity-method investment, or (4) an entity’s own equity instruments.

g. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. Thus, for example, in hedging the exposure to changes in the cash flows relating to the purchase of its bronze bar inventory, an entity may not designate the risk of changes in the cash flows relating to purchasing the copper component in bronze as the risk being hedged for purposes of assessing offset as required by paragraph 28(b).

h. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or
liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in market interest rates, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates (refer to paragraph 40), or (4) the risk of changes in its cash flows attributable to default or changes in the obligor’s creditworthiness. Two or more of the above risks may be designated simultaneously as being hedged. An entity may not designate prepayment risk as the risk being hedged (refer to paragraph 21(f)).

30. The effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income, and the ineffective portion is reported in earnings. More specifically, a qualifying cash flow hedge shall be accounted for as follows:
   a. If an entity’s defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in paragraph 63 in Section 2 of Appendix A), that excluded component of the gain or loss shall be recognized currently in earnings. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the changes in the option’s time value would be recognized in earnings. Time value is equal to the fair value of the option less its intrinsic value.
   b. Accumulated other comprehensive income associated with the hedged transaction shall be adjusted to a balance that reflects the lesser of the following (in absolute amounts):
      (1) The cumulative gain or loss on the derivative from inception of the hedge less (a) the excluded component discussed in paragraph 30(a) above and (b) the derivative’s gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31
      (2) The portion of the cumulative gain or loss on the derivative necessary to offset the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the derivative’s gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31.
   That adjustment of accumulated other comprehensive income shall incorporate recognition in other comprehensive income of part or all of the gain or loss on the hedging derivative, as necessary.
   c. A gain or loss shall be recognized in earnings, as necessary, for any remaining gain or loss on the hedging derivative or to adjust other comprehensive income to the balance specified in paragraph 30(b) above.

Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Examples 6 and 9 of Section 1 of Appendix B illustrate the application of this paragraph.

31. Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings (for example, when a forecasted sale actually occurs). If the hedged transaction results in the acquisition of an asset or the incurrence of a liability, the gains and losses in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the asset acquired or liability incurred affects earnings (such as in the periods that depreciation expense, interest expense, or cost of sales is recognized). However, if an entity expects at any time that continued reporting of a loss in accumulated other comprehensive income would lead to recognizing a net loss on the combination of the hedging instrument and
the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered. For example, a loss shall be reported in earnings for a derivative that is designated as hedging the forecasted purchase of inventory to the extent that the cost basis of the inventory plus the related amount reported in accumulated other comprehensive income exceeds the amount expected to be recovered through sales of that inventory. (Impairment guidance is provided in paragraphs 34 and 35.)

32. An entity shall discontinue prospectively the accounting specified in paragraphs 30 and 31 for an existing hedge if any one of the following occurs:

   a. Any criterion in paragraphs 28 and 29 is no longer met.
   b. The derivative expires or is sold, terminated, or exercised.
   c. The entity removes the designation of the cash flow hedge.

In those circumstances, the net gain or loss shall remain in accumulated other comprehensive income and be reclassified into earnings as specified in paragraph 31. Furthermore, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 32(a) and 32(c), a different hedged transaction or a hedged item if the hedging relationship meets the criteria specified in paragraphs 28 and 29 for a cash flow hedge or paragraphs 20 and 21 for a fair value hedge.

33. If a cash flow hedge is discontinued because it is probable that the original forecasted transaction will not occur, the net gain or loss in accumulated other comprehensive income shall be immediately reclassified into earnings.

34. Existing requirements in generally accepted accounting principles for assessing asset impairment or recognizing an increased obligation apply to an asset or liability that gives rise to variable cash flows (such as a variable-rate financial instrument), for which the variable cash flows (the forecasted transactions) have been designated as being hedged and accounted for pursuant to paragraphs 30 and 31. Those impairment requirements shall be applied each period after hedge accounting has been applied for the period, pursuant to paragraphs 30 and 31 of this Statement. The fair value or expected cash flows of a hedging instrument shall not be considered in applying those requirements. The gain or loss on the hedging instrument in accumulated other comprehensive income shall, however, be accounted for as discussed in paragraph 31.

35. If, under existing requirements in generally accepted accounting principles, an impairment loss is recognized on an asset or an additional obligation is recognized on a liability to which a hedged forecasted transaction relates, any offsetting net gain related to that transaction in accumulated other comprehensive income shall be reclassified immediately into earnings. Similarly, if a recovery is recognized on the asset or liability to which the forecasted transaction relates, any offsetting net loss that has been accumulated in other comprehensive income shall be reclassified immediately into earnings.

Foreign Currency Hedges

36. Consistent with the functional currency concept in Statement 52, an entity may designate the following types of hedges of foreign currency exposure, as specified in paragraphs 37-42:

   a. A fair value hedge of an unrecognized firm commitment or an available-for-sale security
   b. A cash flow hedge of a forecasted foreign-currency-denominated transaction or a forecasted intercompany foreign-currency-denominated transaction
   c. A hedge of a net investment in a foreign operation.

The criterion in paragraph 21(c)(1) requires that a recognized asset or liability that may give rise to a foreign currency transaction gain or loss under Statement 52 (such as a foreign-currency-
denominated receivable or payable) not be the hedged item in a foreign currency fair value or cash flow hedge because it is remeasured with the changes in the carrying amount attributable to what would be the hedged risk (an exchange rate change) reported currently in earnings. Similarly, the criterion in paragraph 29(d) requires that the forecasted acquisition of an asset or the incurrence of a liability that may give rise to a foreign currency transaction gain or loss under Statement 52 not be the hedged item in a foreign currency cash flow hedge because, subsequent to acquisition or incurrence, the asset or liability will be remeasured with changes in the carrying amount attributable to what would be the hedged risk reported currently in earnings. A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in the consolidated financial statements only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

Foreign Currency Fair Value Hedges

37. Unrecognized firm commitment. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22–27 if all the fair value hedge criteria in paragraphs 20 and 21 are met.

38. Available-for-sale security. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security. A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale debt security (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22–27 if all the fair value hedge criteria in paragraphs 20 and 21 are met. An available-for-sale equity security can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for the accounting specified in paragraphs 22–27 only if the fair value hedge criteria in paragraphs 20 and 21 are met and the following two conditions are satisfied:

   a. The security is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor's functional currency.
   b. Dividends or other cash flows to holders of the security are all denominated in the same foreign currency as the currency expected to be received upon sale of the security.

The change in fair value of the hedged available-for-sale equity security attributable to foreign exchange risk is reported in earnings pursuant to paragraph 23 and not in other comprehensive income.

39. Gains and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in paragraphs 22–27. The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under Statement 52. That foreign currency transaction gain or loss shall be recognized currently in earnings along with the change in the carrying amount of the hedged firm commitment.

Foreign Currency Cash Flow Hedges

40. A nonderivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge. A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with either a forecasted foreign-currency-denominated transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency) or a forecasted intercompany foreign-currency-denominated transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all of the following criteria are met:
The operating unit that has the foreign currency exposure is a party to the hedging instrument (which can be an instrument between a parent company and its subsidiary—refer to paragraph 36).

b. The hedged transaction is denominated in a currency other than that unit’s functional currency.

c. All of the criteria in paragraphs 28 and 29 are met, except for the criterion in paragraph 29(c) that requires that the forecasted transaction be with a party external to the reporting entity.

d. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

41. A qualifying foreign currency cash flow hedge shall be accounted for as specified in paragraphs 30–35.

Hedges of the Foreign Currency Exposure of a Net Investment in a Foreign Operation

42. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation. The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with Statement 52; the provisions of this Statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

Accounting by Not-for-Profit Organizations and Other Entities That Do Not Report Earnings

43. An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization or a defined benefit pension plan) shall recognize the gain or loss on a hedging instrument and a nonhedging derivative instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that case, the provisions of paragraph 42 of this Statement shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraph 22 in a fair value hedge as a change in net assets in the period of change. Those entities are not permitted to use cash flow hedge accounting because they do not report earnings separately. Consistent with the provisions of FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, this Statement does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

Disclosures

44. An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42) shall disclose its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. The description shall distinguish between derivative instruments (and nonderivative instruments) designated as fair value hedging instruments, derivative instruments designated as cash flow hedging instruments, derivative instruments (and nonderivative instruments) designated as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, and all other derivatives. The description also shall indicate the entity’s risk management policy for each of those types of hedges, including a description of the items or transactions for which risks are hedged. For derivative instruments not designated as hedging instruments, the description shall indicate the purpose of the derivative activity. Qualitative disclosures about an entity’s objectives and strategies for using derivative instruments may be more meaningful if such objectives and strategies are described in the context of an entity’s overall risk management profile.
appropriate, an entity is encouraged, but not required, to provide such additional qualitative disclosures.

45. An entity’s disclosures for every reporting period for which a complete set of financial statements is presented also shall include the following:

Fair value hedges
a. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as fair value hedging instruments and for the related hedged items:
   (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges’ ineffectiveness and (b) the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
   (2) The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

Cash flow hedges
b. For derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions:
   (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges’ ineffectiveness and (b) the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
   (2) A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months
   (3) The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments
   (4) The amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur.

Hedges of the net investment in a foreign operation
c. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, the net amount of gains or losses included in the cumulative translation adjustment during the reporting period.

The quantitative disclosures about derivative instruments may be more useful, and less likely to be perceived to be out of context or otherwise misunderstood, if similar information is disclosed about other financial instruments or nonfinancial assets and liabilities to which the derivative instruments are related by activity. Accordingly, in those situations, an entity is encouraged, but not required, to present a more complete picture of its activities by disclosing that information.
Reporting Changes in the Components of Comprehensive Income

46. An entity shall display as a separate classification within other comprehensive income the net gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments that are reported in comprehensive income pursuant to paragraphs 30 and 41.

47. As part of the disclosures of accumulated other comprehensive income, pursuant to paragraph 26 of FASB Statement No. 130, Reporting Comprehensive Income, an entity shall separately disclose the beginning and ending accumulated derivative gain or loss, the related net change associated with current period hedging transactions, and the net amount of any reclassification into earnings.

Effective Date and Transition

48. This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 1999. Initial application of this Statement shall be as of the beginning of an entity’s fiscal quarter; on that date, hedging relationships shall be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. Earlier application of selected provisions of this Statement is not permitted. This Statement shall not be applied retroactively to financial statements of prior periods.

49. At the date of initial application, an entity shall recognize all freestanding derivative instruments (that is, derivative instruments other than embedded derivative instruments) in the statement of financial position as either assets or liabilities and measure them at fair value, pursuant to paragraph 17. The difference between a derivative’s previous carrying amount and its fair value shall be reported as a transition adjustment, as discussed in paragraph 52. The entity also shall recognize offsetting gains and losses on hedged assets, liabilities, and firm commitments by adjusting their carrying amounts at that date, as discussed in paragraph 52(b). Any gains or losses on derivative instruments that are reported independently as deferred gains or losses (that is, liabilities or assets) in the statement of financial position at the date of initial application shall be derecognized from that statement; that derecognition also shall be reported as transition adjustments as indicated in paragraph 52. Any gains or losses on derivative instruments reported in other comprehensive income at the date of initial application because the derivative instruments were hedging the fair value exposure of available-for-sale securities also shall be reported as transition adjustments; the offsetting losses and gains on the securities shall be accounted for pursuant to paragraph 52(b). Any gain or loss on a derivative instrument reported in accumulated other comprehensive income at the date of initial application because the derivative instrument was hedging the variable cash flow exposure of a forecasted (anticipated) transaction related to an available-for-sale security shall remain in accumulated other comprehensive income and shall not be reported as a transition adjustment. The accounting for any gains and losses on derivative instruments that arose prior to the initial application of the Statement and that were previously added to the carrying amount of recognized hedged assets or liabilities is not affected by this Statement. Those gains and losses shall not be included in the transition adjustment.

50. At the date of initial application, an entity also shall recognize as an asset or liability in the statement of financial position any embedded derivative instrument that is required pursuant to paragraphs 12–16 to be separated from its host contract if the hybrid instrument in which it is embedded was issued, acquired, or substantively modified by the entity after December 31, 1997. For all of its hybrid instruments that exist at the date of initial application and were issued or acquired before January 1, 1998 and not substantively modified thereafter, an entity may choose either (a) not to apply this Statement to any of those hybrid instruments or (b) to recognize as assets or liabilities all the derivative instruments embedded in those hybrid instruments that would be required pursuant to paragraphs 12–16 to be separated from their host contracts. That choice is not permitted to be applied to only some of an entity’s individual hybrid instruments and must be applied on an all-or-none basis.
51. If an embedded derivative instrument is to be separated from its host contract in conjunction with the initial application of this Statement, the entity shall consider the following in determining the related transition adjustment:

a. The carrying amount of the host contract at the date of initial application shall be based on its fair value on the date that the hybrid instrument was issued or acquired by the entity and shall reflect appropriate adjustments for subsequent activity, such as subsequent cash receipts or payments and the amortization of any premium or discount on the host contract arising from the separation of the embedded derivative.

b. The carrying amount of the embedded derivative instrument at the date of initial application shall be its fair value.

c. The transition adjustment shall be the difference at the date of initial application between (1) the previous carrying amount of the hybrid instrument and (2) the sum of the new net carrying amount of the host contract and the fair value of the embedded derivative instrument. The entity shall not retroactively designate a hedging relationship that could have been made had the embedded derivative instrument initially been accounted for separate from the host contract.

52. The transition adjustments resulting from adopting this Statement shall be reported in net income or other comprehensive income, as appropriate, as the effect of a change in accounting principle and presented in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, Accounting Changes. Whether a transition adjustment related to a specific derivative instrument is reported in net income, reported in other comprehensive income, or allocated between both is based on the hedging relationships, if any, that had existed for that derivative instrument and that were the basis for accounting under generally accepted accounting principles before the date of initial application of this Statement.

a. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment shall be reported as a cumulative-effect-type adjustment of accumulated other comprehensive income.

b. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the fair value exposure of an asset, a liability, or a firm commitment, the transition adjustment for the derivative shall be reported as a cumulative-effect-type adjustment of net income. Concurrently, any gain or loss on the hedged item (that is, difference between the hedged item’s fair value and its carrying amount) shall be recognized as an adjustment of the hedged item’s carrying amount at the date of initial application, but only to the extent of an offsetting transition adjustment for the derivative. That adjustment of the hedged item’s carrying amount shall also be reported as a cumulative-effect-type adjustment of net income. The transition adjustment related to the gain or loss reported in accumulated other comprehensive income on a derivative instrument that hedged an available-for-sale security, together with the loss or gain on the related security (to the extent of an offsetting transition adjustment for the derivative instrument), shall be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated other comprehensive income.

c. If a derivative instrument had been designated in multiple hedging relationships that addressed both the fair value exposure of an asset or a liability and the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment for the derivative shall be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of accumulated other comprehensive income and shall be reported as discussed in paragraphs 52(a) and 52(b) above. Concurrently, any gain or
loss on the hedged item shall be accounted for at the date of initial application as discussed in paragraph 52(b) above.

d. Other transition adjustments not encompassed by paragraphs 52(a), 52(b), and 52(c) above shall be reported as part of the cumulative-effect-type adjustment of net income.

53. Any transition adjustment reported as a cumulative-effect-type adjustment of accumulated other comprehensive income shall be subsequently reclassified into earnings in a manner consistent with paragraph 31. For those amounts, an entity shall disclose separately in the year of initial application the amount of gains and losses reported in accumulated other comprehensive income and associated with the transition adjustment that are being reclassified into earnings during the 12 months following the date of initial application.

54. At the date of initial application, an entity may transfer any held-to-maturity security into the available-for-sale category or the trading category. An entity will then be able in the future to designate a security transferred into the available-for-sale category as the hedged item, or its variable interest payments as the cash flow hedged transactions, in a hedge of the exposure to changes in market interest rates, changes in foreign currency exchange rates, or changes in its overall fair value. (Paragraph 21(d) precludes a held-to-maturity security from being designated as the hedged item in a fair value hedge of market interest rate risk or the risk of changes in its overall fair value. Paragraph 29(e) similarly precludes the variable cash flows of a held-to-maturity security from being designated as the hedged transaction in a cash flow hedge of market interest rate risk.) The unrealized holding gain or loss on a held-to-maturity security transferred to another category at the date of initial application shall be reported in net income or accumulated other comprehensive income consistent with the requirements of paragraphs 15(b) and 15(c) of Statement 115 and reported with the other transition adjustments discussed in paragraph 52 of this Statement. Such transfers from the held-to-maturity category at the date of initial adoption shall not call into question an entity’s intent to hold other debt securities to maturity in the future.

55. At the date of initial application, an entity may transfer any available-for-sale security into the trading category. After any related transition adjustments from initially applying this Statement have been recognized, the unrealized holding gain or loss remaining in accumulated other comprehensive income for any transferred security at the date of initial application shall be reclassified into earnings (but not reported as part of the cumulative-effect-type adjustment for the transition adjustments), consistent with paragraph 15(b) of Statement 115. If a derivative instrument had been hedging the variable cash flow exposure of a forecasted transaction related to an available-for-sale security that is transferred into the trading category at the date of initial application and the entity had reported a gain or loss on that derivative instrument in other comprehensive income (consistent with paragraph 115 of Statement 115), the entity also shall reclassify those derivative gains and losses into earnings (but not report them as part of the cumulative-effect-type adjustment for the transition adjustments).

56. At the date of initial application, mortgage bankers and other servicers of financial assets may choose to restratify their servicing rights pursuant to paragraph 37(g) of Statement 125 in a manner that would enable individual strata to comply with the requirements of this Statement regarding what constitutes “a portfolio of similar assets.” As noted in footnote 9 of this Statement, mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 37(g) of Statement 125 would not necessarily comply with the requirement in paragraph 21(a) of this Statement for portfolios of similar assets, since the risk stratum under paragraph 37(g) of Statement 125 can be based on any predominant risk characteristic, including date of origination or geographic location. The restratification of servicing rights is a change in the application of an accounting principle, and the effect of that change as of the initial application of this Statement shall be reported as part of the cumulative-effect-type adjustment for the transition adjustments.
65. FAS 137 provides the following:

Amendments to Statement 133
3. Statement 133 is amended as follows:

a. The first sentence of paragraph 48 is replaced by the following:

This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000.

b. Paragraph 50 is replaced by the following:

At the date of initial application, an entity shall choose to either (a) recognize as an asset or liability in the statement of financial position all embedded derivative instruments that are required pursuant to paragraphs 12–16 to be separated from their host contracts or (b) select either January 1, 1998 or January 1, 1999 as a transition date for embedded derivatives. If the entity chooses to select a transition date, it shall recognize as separate assets and liabilities (pursuant to paragraphs 12–16) only those derivatives embedded in hybrid instruments issued, acquired, or substantively modified by the entity on or after the selected transition date. That choice is not permitted to be applied to only some of an entity’s individual hybrid instruments and must be applied on an all-or-none basis.

Effective Date
4. This Statement is effective upon issuance. An entity that has already applied the provisions of Statement 133 and has issued interim or annual financial statements reflecting that application may not revert to a previous method of accounting for derivative instruments and hedging activities.

66. FAS 138 provides the following (certain sections not affecting the excerpted FAS No. 133 guidance excluded):

Amendments to Statement 133
4. Statement 133 is amended as follows:

Amendment Related to Normal Purchases and Normal Sales
a. Paragraph 10(b) is replaced by the following:

Normal purchases and normal sales. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets neither of the criteria in paragraphs 15(a) and 15(b) shall not be considered normal purchases and normal sales. Contracts that contain net settlement provisions as described in paragraphs 9(a) and 9(b) may qualify for the normal purchases and normal sales exception if it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a
series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception. For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the basis for concluding that it is probable that the contract will result in physical delivery. The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract.

Amendments to Redefine Interest Rate Risk

b. Paragraph 21 is amended as follows:

(1) The first sentence of subparagraph (d) is replaced by the following:

If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, the designated risk being hedged is the risk of changes in its fair value attributable to credit risk, foreign exchange risk, or both. If the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.

(2) In the first parenthetical sentence of subparagraph (d), changes in market interest rates or foreign exchange rates is replaced by interest rate risk.

(3) In subparagraph (f)(2), market interest rates is replaced by the designated benchmark interest rate (referred to as interest rate risk).

(4) In subparagraph (f)(3), (refer to paragraphs 37 and 38) is replaced by (referred to as foreign exchange risk) (refer to paragraphs 37, 37A, and 38).

(5) In subparagraph (f)(4), both is inserted between to and changes and the obligor’s creditworthiness is replaced by the obligor’s creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge (referred to as credit risk).

(6) In the second sentence of subparagraph (f), market is deleted.

(7) In subparagraph (f), the following sentences and footnote are added after the second sentence:

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item’s fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item’s contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.

(8) In the fourth sentence of subparagraph (f), overall is inserted between exposure to changes in the and fair value of that.

(9) In the last sentence of subparagraph (f), market is deleted.
c. Paragraph 29 is amended as follows:

(1) In the first sentence of subparagraph (e), default or changes in the obligor’s creditworthiness is replaced by credit risk, foreign exchange risk, or both.

(2) In the last sentence of subparagraph (e), changes in market interest rates is replaced by interest rate risk.

(3) In the first sentence of subparagraph (h), (or the interest payments on that financial asset or liability) is added after sale of a financial asset or liability.

(4) In subparagraph (h)(1), the risk of changes in the cash flows of the entire asset or liability is replaced by the risk of overall changes in the hedged cash flows related to the asset or liability.

(5) In subparagraph (h)(2), market interest rates is replaced by the designated benchmark interest rate (referred to as interest rate risk).

(6) In subparagraph (h)(3), (refer to paragraph 40) is replaced by (referred to as foreign exchange risk) (refer to paragraphs 40, 40A, 40B, and 40C).

(7) In subparagraph (h)(4), default or changes in the obligor’s creditworthiness is replaced by default, changes in the obligor’s creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge (referred to as credit risk).

(8) In subparagraph (h), the following sentences are added after the second sentence:

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified.

In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, for example, based on a specific bank’s prime rate, which cannot qualify as the benchmark rate. However, the risk designated as being hedged could potentially be the risk of overall changes in the hedged cash flows related to the asset or liability, provided that the other criteria for a cash flow hedge have been met.

d. Paragraph 54 is amended as follows:

(1) In the second sentence, market interest rates, changes in foreign currency exchange rates, is replaced by the designated benchmark interest rate.

(2) In the third and fourth (parenthetical) sentences, market is deleted.

(3) In the penultimate sentence of footnote 14, market interest rates is replaced by interest rate risk.

e. In the first sentence of paragraph 90, market is deleted.

Amendments Related to Hedging Recognized Foreign-Currency-Denominated Assets and Liabilities

f. In paragraph 21(c)(1), (for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings) is deleted.

g. Paragraph 29(d) is amended as follows:

1) In the first sentence, (for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings) is deleted.

2) The second sentence is deleted.
h. In paragraph 29(g)(2), (reflecting its actual location if a physical asset) is replaced by reflecting its actual location if a physical asset (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency).

i. The following subparagraph is added after subparagraph (c) of paragraph 30:

d. In a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52, an amount that will offset the related transaction gain or loss arising from the remeasurement and adjust earnings for the cost to the purchaser (income to the seller) of the hedging instrument shall be reclassified each period from other comprehensive income to earnings.

j. Paragraph 36 is amended as follows:
(1) In the first sentence, Consistent with the functional currency concept in Statement 52 is replaced by If the hedged item is denominated in a foreign currency.
(2) In subparagraph (a), an available-for-sale security is replaced by a recognized asset or liability (including an available-for-sale security).
(3) Subparagraph (b) is replaced by the following:
A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction.
(4) The first two sentences following subparagraph (c) are replaced by the following:
The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings, which is discussed in the criteria in paragraphs 21(c)(1) and 29(d). Thus, those criteria are not impediments to either a foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability or a foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates under paragraph 15 of Statement 52.

k. The following paragraph is added after paragraph 36:
36A. The provisions in paragraph 36 that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated sale or purchase on credit. An entity may choose to designate a single cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit. Alternatively, an entity may choose to designate a cash flow hedge of the variability of functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. In that case, the cash flow hedge would terminate (be redesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. The use of the same foreign currency derivative instrument for both the cash flow
hedge and the fair value hedge is not prohibited though some ineffectiveness may result.

l. The following paragraph is added after paragraph 37:

37A. Recognized asset or liability. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability. A derivative instrument can be designated as hedging the changes in the fair value of a recognized asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of Statement 52. All recognized foreign-currency-denominated assets or liabilities for which a foreign currency transaction gain or loss is recorded in earnings may qualify for the accounting specified in paragraphs 22-27 if all the fair value hedge criteria in paragraphs 20 and 21 and the conditions in paragraphs 40(a) and 40(b) are met.

m. Paragraph 40 is amended as follows:

(1) The second sentence is replaced by the following:

A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a forecasted transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency), a recognized asset or liability, an unrecognized firm commitment, or a forecasted intercompany transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all the following criteria are met:

(2) The following subparagraph is added:

e. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item’s functional-currency-equivalent cash flows must be eliminated by the effect of the hedge. (For example, a cash flow hedge cannot be used with a variable-rate foreign-currency-denominated asset or liability and a derivative based solely on changes in exchange rates because the derivative does not eliminate all the variability in the functional currency cash flows.)

Amendments Related to Intercompany Derivatives

n. In the last sentence of paragraph 36, in a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge is added after can be a hedging instrument.

o. The following paragraphs are added after paragraph 40:

40A. Internal derivative. A foreign currency derivative contract that has been entered into with another member of a consolidated group (such as a treasury center) can be a hedging instrument in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if the following two conditions are satisfied. (That foreign currency derivative instrument is hereafter in this section referred to as an internal derivative.)

a. From the perspective of the member of the consolidated group using the derivative as a hedging instrument (hereafter in this section referred to as the hedging affiliate), the criteria for foreign currency cash flow hedge accounting in paragraph 40 must be satisfied.

b. The member of the consolidated group not using the derivative as a hedging instrument (hereafter in this section referred to as
the issuing affiliate) must either (1) enter into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative or (2) if the conditions in paragraph 40B are met, enter into derivative contracts with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts.

40B. Offsetting net exposures. If an issuing affiliate chooses to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis, the derivatives issued to hedging affiliates may qualify as cash flow hedges in the consolidated financial statements only if all of the following conditions are satisfied:

a. The issuing affiliate enters into a derivative contract with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts, and the derivative contract with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative contracts issued to affiliates.

b. Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative. In addition, nonderivative contracts may not be used as hedging instruments to offset exposures arising from internal derivative contracts.

c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivative contracts that mature within the same 31-day period and that involve the same currency exposure as the net third-party derivative. The offsetting net third-party derivative related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments.

d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each internal derivative contract and the offsetting aggregate or net derivative contract with an unrelated third party.

e. The issuing affiliate does not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate any offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative.

40C. A member of a consolidated group is not permitted to offset exposures arising from multiple internal derivative contracts on a net basis for foreign currency cash flow exposures related to recognized foreign-currency-denominated assets or liabilities. That prohibition includes situations in which a recognized foreign-currency-denominated asset or liability in a fair value hedge or cash flow hedge results from the occurrence of a specifically identified forecasted transaction initially designated as a cash flow hedge.

Amendments for Certain Interpretations of Statement 133 Cleared by the Board Relating to the Derivatives Implementation Group Process

p. In the second sentence of paragraph 12, host is inserted between would be required by the and contract, whether unconditional.

q. Paragraph 33 is replaced by the following:

The net derivative gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter, except as indicated in the following sentence. In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time, in which case the net derivative gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraph 31. If it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified time period or within the additional two-month period of time and the hedged forecasted transaction also does not qualify for the exception described in the preceding sentence, that derivative gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately.

r. The following is added at the end of paragraph 45(b)(4):

by the end of the originally specified time period or within the additional period of time discussed in paragraph 33.

Amendments to Implement Guidance in Implementation Issue No. H1, “Hedging at the Operating Unit Level”

s. In the last sentence of paragraph 37, and the conditions in paragraphs 40(a) and 40(b) is added between paragraphs 20 and 21 and are met.

t. In the third sentence of paragraph 38, and the conditions in paragraphs 40(a) and 40(b) is added between paragraphs 20 and 21 and are met.

u. In paragraph 42, provided the conditions in paragraphs 40(a) and 40(b) are met is added to the end of the first sentence.

Amendments to Implement Guidance in Implementation Issue No. H2, “Requirement That the Unit with the Exposure Must Be a Party to the Hedge”

v. Paragraph 40 is amended as follows:

(1) Subparagraph (a) is replaced by the following:

For consolidated financial statements, either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit (subject to the restrictions in this subparagraph and related footnote) is a party to the hedging instrument. To qualify for applying the guidance in (2) above, there may be no intervening subsidiary with a different functional currency. (Refer to paragraphs 36, 40A, and 40B for conditions for which an intercompany foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.)

(2) In subparagraph (b), that is replaced by the hedging.
OTHER SOURCES OF INFORMATION:

67. The Financial Accounting Standards Board established the Derivatives Implementation Group to address execution of FAS No. 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this issue paper. The issues have been authored by the FASB staff and represents the staff’s views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation. E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges and E8: Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach are included as part of Exhibit A:

RELEVANT LITERATURE:

Statutory Accounting
- Statement of Statutory Accounting Principle No. 31 – Derivative Instruments
- Minutes of the June 7, 1999 Emerging Accounting Issues working group meeting

Generally Accepted Accounting Principles
- FASB Statement No. 80, Accounting for Futures Contracts
- FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities
- FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 - an amendment of FASB Statement No. 133
- FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities - an amendment of FASB Statement No. 133
- EITF 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities
- EITF 98-12, Application of Issue No. 96-13 to Forward Equity Sales Transactions
- EITF 99-01, Accounting for Debt Convertible into the Stock of a Consolidated Sub
- EITF 99-02, Accounting for Weather Derivatives
- EITF 99-03, Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives
- EITF 99-08, Accounting for Transfers of Assets That Are Derivative Instruments but That Are Not Financial Assets
- EITF 99-09, Effect of Derivative Gains and Losses on the Capitalization of Interest
- EITF 00-07, Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur
- EITF 00-09, Classification of a Gain or Loss from a Hedge of Debt That Is Extinguished
EXHIBIT A - DISCUSSION OF HEDGING EFFECTIVENESS

The Financial Accounting Standards Board established the Derivatives Implementation Group in 1999 to address execution of FAS No. 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this issue paper. The issues have been authored by the FASB staff and represents the staff’s views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation.

No. E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

Paragraph references: 20(b), 22, 28(b), 62, 86, 87
Date cleared by Board: May 17, 2000

QUESTION

1. Since Statement 133 provides an entity with flexibility in choosing the method it will use in assessing hedge effectiveness, must an entity use a dollar-offset approach in assessing effectiveness?

BACKGROUND

2. Paragraph 20(b) of Statement 133 states, in part:

   Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.

3. Paragraph 28(b) indicates a similar requirement that the hedging relationship be expected to be highly effective in achieving offsetting changes in cash flows attributable to the hedged risk during the period that the hedge is designated.

4. Paragraph 22 of Statement 133 states, in part:

   The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20(a). Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved.

5. Paragraph 62 emphasizes that each entity must “define at the time it designates a hedging relationship the method it will use to assess the hedge’s effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged.” It also states, “This Statement does not specify a single method for either assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness.”

RESPONSE

6. No. Statement 133 requires an entity to consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations.
a. Prospective considerations

Upon designation of a hedging relationship (as well as on an ongoing basis), the entity must be able to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows. That expectation, which is forward-looking, can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.

b. Retrospective evaluations

At least quarterly, the hedging entity must determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment. That assessment can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. If an entity elects at the inception of a hedging relationship to utilize the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship those regression analysis calculations should generally incorporate the same number of data points. Electing to utilize a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period as discussed below.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge’s effectiveness. That paragraph also states that ordinarily “an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.” Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at the inception of a hedging relationship to utilize a regression analysis approach for prospective considerations of assessing effectiveness and the dollar-offset method to perform retrospective evaluations of assessing effectiveness, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Thus, in its retrospective evaluation, an entity might conclude that, under a dollar-offset approach, a designated hedging relationship does not qualify for hedge accounting for the period just ended, but that the hedging relationship may continue because, under a regression analysis approach, there is an expectation that the relationship will be highly effective in achieving offsetting changes in fair value or cash flows in future periods. In its retrospective evaluation, if that entity concludes that, under a dollar-offset approach, the hedging relationship has not been highly effective in having achieved offsetting changes in fair value or cash flows, hedge accounting may not be applied in the current period. Whenever a hedging relationship fails to qualify for hedge accounting in a certain assessment period, the overall change in fair value of the derivative for that current period is recognized in earnings (not reported in other comprehensive income for a cash flow hedge) and the change in fair value of the hedged item would not be recognized in earnings for that period (for a fair value hedge).

8. If an entity elects at the inception of a hedging relationship to utilize a regression analysis (or other statistical analysis) approach for either prospective considerations or retrospective evaluations of assessing effectiveness, then that entity must periodically update its regression analysis (or other statistical analysis). For example, if there is significant ineffectiveness measured and recognized in earnings for a hedging relationship, which is calculated each assessment period, the regression analysis should be rerun to determine whether the expectation of high effectiveness is still valid. As long as an entity reruns its regression analysis and determines that the hedging relationship is still expected to be highly effective, then it can continue to apply hedge accounting without interruption.
9. In all instances, the actual measurement of hedge ineffectiveness to be recognized in earnings each reporting period is based on the extent to which exact offset is not achieved as specified in paragraph 22 of Statement 133 (for fair value hedges) or paragraph 30 (for cash flow hedges). That requirement applies even if a regression or other statistical analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness supports an expectation that the hedging relationship will be highly effective and demonstrates that it has been highly effective, respectively.

10. The application of a regression or other statistical analysis approach to assessing effectiveness is complex. Those methodologies require appropriate interpretation and understanding of the statistical inferences.

E8: Hedging–General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach

Paragraph references: 20(b), 28(b), 30, 62, 64, 67
Date cleared by Board: June 28, 2000

QUESTION

1. In periodically assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows), an entity compares the change in the hedging instrument’s fair value (or cash flows) to the change in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the hedged risk. If an entity elects at inception of a hedging relationship to utilize the dollar-offset approach for retrospective evaluations of assessing effectiveness, then should that entity base that comparison on (a) the fair value (or cash flow) changes that have occurred during the period being assessed (that is, on a period-by-period basis) or (b) the cumulative fair value (or cash flow) changes to date from the inception of the hedge? Is that entity permitted to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges) under a dollar-offset approach?

BACKGROUND

2. Paragraph 20(b) of Statement 133 states, in part:

   Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months….All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship.

3. Paragraph 28(b) states, in part:

   Both at inception of the [cash flow] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months….All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

4. Paragraph 30(b) states that “the effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income.” Paragraph 30(b) specifies how the effective portion to be reported in other comprehensive income should be calculated. The calculation of
the effective portion is, in part, based on “cumulative gain or loss on the derivative from inception of the hedge.”

5. Paragraph 67 of the Statement states, in part:

If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test and also would measure any ineffectiveness during the hedge period. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting.

RESPONSE

6. In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach, Statement 133 permits an entity to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges). The period-by-period approach involves comparing the changes in the hedging instrument’s fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the risk hedged that have occurred during the same period. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument’s fair values (or cash flows) to the cumulative changes in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the risk hedged. At inception of the hedge, an entity may choose either approach in designating how effectiveness will be assessed, depending on the nature of the hedge documented in accordance with paragraphs 20(a) and 28(a). For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge’s effectiveness. That paragraph also states that ordinarily “an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.” Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period.

8. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods prior to the period being assessed are not relevant.

9. The foregoing guidance relates to an entity’s periodic retrospective assessment and determining whether a hedging relationship continues to qualify for hedge accounting; it does not relate to the actual measurement of hedge ineffectiveness to be recognized in earnings under hedge accounting. The actual measurement of ineffectiveness is based on the extent to which exact offset is not achieved as specified in paragraph 22 for fair value hedges or paragraph 30 for cash flow hedges.

10. The above response has been authored by the FASB staff and represents the staff’s views, although the Board has discussed the above response at a public meeting and chosen not to object to
EXHIBIT B – ASSESSMENT OF HEDGING EFFECTIVENESS

The following is based on paragraphs 62-70 of FAS 133 to offer additional guidance on assessing hedging effectiveness. The intent of such is to remain consistent with FAS 133 with respect to assessing hedge effectiveness.

1. This issue paper requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge’s effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Although this issue paper suggests a method for assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness, the appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.

2. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. This issue paper permits (but does not require) an entity to exclude all or a part of the hedging instrument’s time value from the assessment of hedge effectiveness, as follows:

   a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.

   b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.

   c. If the effectiveness of a hedge with a forward or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price would be excluded from the assessment of hedge effectiveness.

In each circumstance above, changes in the excluded component would be included in unrealized gains or losses. As noted in paragraph 1, the effectiveness of similar hedges generally should be assessed similarly; that includes whether a component of the gain or loss on a derivative is excluded in assessing effectiveness. No other components of a gain or loss on the designated hedging instrument may be excluded from the assessment of hedge effectiveness.

3. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by...
comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

4. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess. If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective if:

   a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.
   b. The fair value of the forward contract at inception is zero.
   c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in unrealized gains and losses pursuant to paragraph 22B or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

5. However, assessing hedge effectiveness can be more complex. For example, hedge effectiveness would be reduced by the following circumstances, among others: a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark-based hedging instrument and Dutch guilder-based hedged item), to the extent that those bases do not move in tandem. b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in notional amounts, maturities, quantity, location, or delivery dates. Hedge effectiveness also would be reduced if part of the change in the fair value of a derivative is attributable to a change in the counterparty’s creditworthiness.

6. A hedge that meets the effectiveness test specified in paragraphs 20 b. and 21 b. (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. The discussions of measuring hedge effectiveness in the examples in the remainder of this Exhibit assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Assuming Effectiveness in a Hedge with an Interest Rate Swap

7. An entity may assume effectiveness in a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met:

   Conditions applicable to both fair value hedges and cash flow hedges

   a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability.
   b. The fair value of the swap at its inception is zero.
   c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
   d. The interest-bearing asset or liability is not prepayable.
e. Any other terms in the interest-bearing financial instruments or interest rate swaps are
typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only

f. The expiration date of the swap matches the maturity date of the interest-bearing asset or
liability.
g. There is no floor or ceiling on the variable interest rate of the swap.
h. The interval between repricings of the variable interest rate in the swap is frequent
enough to justify an assumption that the variable payment or receipt is at a market rate
(generally three to six months or less).

Conditions applicable to cash flow hedges only

i. All interest receipts or payments on the variable-rate asset or liability during the term of
the swap are designated as hedged, and no interest payments beyond the term of the swap
are designated as hedged.
j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate
asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the
variable interest rate that is comparable to the floor or cap on the variable-rate asset or
liability. (For this purpose, comparable does not necessarily mean equal. For example, if
a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10
percent cap on the swap would be comparable to a 12 percent cap on the asset.)
k. The repricing dates match those of the variable-rate asset or liability.
l. The index on which the variable rate is based matches the index on which the asset or
liability’s variable rate is based.

8. The fixed rate on a hedged item need not exactly match the fixed rate on a swap designated as a
fair value hedge. Nor does the variable rate on an interest-bearing asset or liability need to be the same as
the variable rate on a swap designated as a cash flow hedge. A swap’s fair value comes from its net
settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if
both are changed by the same amount. That is, a swap with a payment based on LIBOR and a receipt
based on a fixed rate of 5 percent has the same net settlements and fair value as a swap with a payment
based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.

9. Comparable credit risk at inception is not a condition for assuming effectiveness even though
actually achieving perfect offset would require that the same discount rate be used to determine the fair
value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate,
the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing
asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash
flow hedge) would have to be the same. However, because that complication is caused by the interaction
of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not
considered a necessary condition to assume no ineffectiveness in a hedge of interest rate risk.
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Statutory Issue Paper No. 116

Claim Adjustment Expenses, Amendments to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses

STATUS
Finalized October 16, 2001

Type of Issue:
Life and Health, Health Entities

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principles No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses (SSAP No. 55) prescribes the accounting treatment for recording unpaid claims and claim adjustment expenses for life insurance contracts and accident and health contracts and unpaid losses and loss adjustment expenses for property and casualty insurance contracts.

2. The purpose of this issue paper is to amend SSAP No. 55 to provide clarification regarding what costs should be classified as claim adjustment expenses on accident and health contracts. The conclusions outlined in the issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

RECOMMENDED CONCLUSION

3. Certain claim adjustment expenses reduce the number or cost of health services thereby resulting in lower premiums or lower premium increases. These claim adjustment expenses shall be classified as cost containment expenses.

4. This issue paper amends paragraph 6 c. of SSAP No. 55 to the following:

   c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6 a. and 6 b. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses:

   i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

      (a) Case management activities;
      (b) Utilization review;
      (c) Detection and prevention of payment for fraudulent requests for reimbursement;
      (d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;
(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 6 c. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;

(b) Maintaining records, general clerical, and secretarial;

(c) Office maintenance, occupancy costs, utilities, and computer maintenance;

(d) Supervisory and executive duties; and

(e) Supplies and postage.

5. This issue paper amends paragraph 7 b. of SSAP No. 55 to the following:

b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 7 a. of this statement. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses:

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

(a) Case management activities;

(b) Utilization review;

(c) Detection and prevention of payment for fraudulent requests for reimbursement;

(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.
ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 7 b. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;
(b) Maintaining records, general clerical, and secretarial;
(c) Office maintenance, occupancy costs, utilities, and computer maintenance;
(d) Supervisory and executive duties; and
(e) Supplies and postage.

Effective Date
6. This issue paper is effective for years ending on and after December 31, 2003.

DISCUSSION
7. In the past, no definitive statutory guidance existed addressing claim adjustment expenses and which expenses should be classified as claim adjustment expenses. In January 2000, the Statutory Accounting Principles Working Group requested assistance from the Accident and Health Working Group of the Life and Health Actuarial Task Force (A&HWG) in providing clarification as to what expenses should be classified as claim adjustment expenses and whether certain claim adjustment expenses should receive special treatment for reporting purposes. The A&HWG made its final recommendations at its March 23, 2001 meeting. The A&HWG determined that claim adjustment expenses shall be subdivided into cost containment expenses and other claim adjustment expenses. The A&HWG also developed a list of items that qualify as cost containment expenses and other claim adjustment expenses. This issue paper adopts the recommendations of the A&HWG.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. SSAP No. 55, paragraph 6.c.:

6.c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6 a. and 6 b. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

9. SSAP No. 55, paragraph 7.b.:

7.b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 7 a. of this statement. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

10. The Accident and Health Working Group of the Life and Health Actuarial Task Force (A&HWG) reviewed in detail the topics of claim adjustment expenses and medical cost containment expenses and
whether certain claim adjustment expenses should be included in losses or loss adjustment expenses. The A&HWG made its final recommendations at its March 23, 2001 meeting. The conclusion of this issue paper is consistent with the A&HWG’s recommendation. The applicable section of the minutes is included herein:

At the 2000 Spring National Meeting, a request for assistance concerning codification issues was received from the Statutory Accounting Principles (E) Working Group (pages 90-91 of the Life and Health Actuarial Subscription, February 2000). The Accident and Health Working Group sent preliminary recommendations to the Statutory Accounting (E) Principles Working Group at the Fall National Meeting (Attachment Seven-B of the Accident and Health Working Group’s Sept. 8, 2000, minutes). The recommendations addressed whether cost containment expenses should be included in losses or loss adjustment expenses. The Codification Subteam of the Accident and Health Working Group continued work on addressing how the prior recommendations could be implemented into the Health Annual Statement and in the Life, Accident and Health Annual Statement. This was the focus of the Feb. 15 and March 2 conference calls.

At the 2001 Spring National Meeting, John Rink (NE), chair of the Codification Subteam, reviewed the proposed memorandum to the Statutory Accounting Principles (E) Working Group. Mr. Rink noted that the recommendations in the proposed memorandum were designed to generate minimal changes to the annual statements, but still implement the prior recommendations of the Accident and Health Working Group.

Mike Batte (NM) moved, John Hartnedy (AR) seconded and the working group agreed to forward the recommendations with the proposed revisions to the Statutory Accounting (E) Principles Working Group. The final memo to the Statutory Accounting Principles (E) Working Group is Attachment Twelve-A.

Applicable excerpts from Attachment Twelve-A to the minutes of the March 23, 2001, meeting of the Accident and Health Working Group of the Life and Health Actuarial Task Force are included herein:

The Accident and Health Working Group (A&HWG) addressed cost containment expenses in a Sept. 11, 2000, memorandum to the Statutory Accounting Principles Working Group. This document is Attachment Seven-B of the Sept. 8, 2000 minutes of the Accident and Health Working Group and may be found on pages 160-162 of the Sept. 2000 Life & Health Actuarial Subscription.

In that memorandum, nine items were identified that could be considered cost containment expenses. Those nine items were further divided into two groupings. One grouping included the following expenses:

1. Clinical quality assurance and other types of medical care quality improvement efforts.
2. Provider contracting and credentialing costs.
3. Consumer education not exclusively relating to health improvement, such as newsletters and e-mails designed to provide health improvement ideas.

Another grouping identified in the Sept. 11 memorandum included the following expenses:

1. Case management activities.
2. Concurrent utilization review.
3. Prospective utilization review.
4. Detection and prevention of payment for fraudulent requests for reimbursement.
5. Network access fees to Preferred Provider Organizations and other network-based health plans, including prescription drug networks.
6. Consumer education solely relating to health improvement and relying on the direct involvement of health personnel. This would include smoking cessation and disease management programs, and other programs that involve hands on medical education.
These expenses reduce the number or cost of health services, which results in lower premiums or lower premium increases. These six expenses will be the only expenses referenced as “cost containment expenses” in this memorandum.

In the Sept. 11 memorandum, the A&HWG recommended that cost containment expenses, as identified above, be included as losses for statutory reporting purposes, and that quality assurance expenses not be included as losses for statutory reporting. The remainder of this memorandum addresses how the Sept. 11 recommendations may be implemented in the Health Blank and in the Life, Accident and Health Blank.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 55—*Unpaid Claims, Losses and Loss Adjustment Expenses*
EXHIBIT A: Illustration of Marked Changes to Amended SSAPs

The following depicts the amendments made by this issue paper as “marked changes” (new text underlined and deleted text struck-through):

SSAP No. 55 paragraph 6 c.:

c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6 a. and 6 b. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses. Examples of expenses incurred in these activities are:

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

   (a) Case management activities;
   (b) Utilization review;
   (c) Detection and prevention of payment for fraudulent requests for reimbursement;
   (d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;
   (e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands-on medical education); and
   (f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 6 c. that are not cost containment expenses. Examples of other claim adjustment expenses are:

   (a) Estimating the amounts of losses and disbursing loss payments.
   (b) Maintaining records, general clerical, and secretarial.
   (c) Office maintenance, occupancy costs, utilities, and computer maintenance.
   (d) Supervisory and executive duties and
   (e) Supplies and postage.
SSAP No. 55 paragraph 7 b.:

b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 7 a. of this statement. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses. Examples of expenses incurred in these activities are:

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

(a) Case management activities;
(b) Utilization review;
(c) Detection and prevention of payment for fraudulent requests for reimbursement;
(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;
(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and
(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 7 b. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;
(b) Maintaining records, general clerical, and secretarial;
(c) Office maintenance, occupancy costs, utilities, and computer maintenance;
(d) Supervisory and executive duties and
(e) Supplies, and postage;
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Statutory Issue Paper No. 118

Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 46

STATUS:
Finalized Dec. 9, 2002

Type of Issue:
Common Area

1. The purpose of this issue paper is to establish statutory accounting principles for investments in subsidiaries, controlled and affiliated entities (hereinafter referred to as SCA entities) that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. This issue paper replaces the conclusions reached in SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46) and nullifies the following interpretations of the Emerging Accounting Issues Working Group:

   a. INT 99-03 – Accounting for Investment in Subsidiary, Controlled or Affiliated Entities with Subsequent Downstream Investment in an Insurance Company
   b. INT 99-28 – Accounting for SCA Mutual Funds, Broker-Dealers and Similar Entities Under SSAP No. 46
   c. INT 00-01 – Investment in a Foreign SCA Entity
   d. INT 01-22 – Use of Interim Financial Statements in Computing Reporting Entity’s Investment in Subsidiary Under the GAAP Equity Method (conclusion was incorporated into SSAP)
   e. INT 01-24 – Application of SSAP No. 46 and 48 to Certain Noninsurance Subsidiary, Controlled or Affiliated Entities

SUMMARY CONCLUSION

Definitions

3. The interpretations of the Emerging Accounting Issues Working Group, which interpret SSAP No. 46 that are affected by the new SSAP, which will be the result of this issue paper, will be identified in the new SSAP.

4. Parent and subsidiary are defined as follows:

   a. Parent—An entity that directly or indirectly owns and controls the reporting entity;
   b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.
5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48). Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18, provides guidance on determining when such evidence exists. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

8. Investments in SCA entities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

Applying the Market Valuation, Audited Statutory Equity and Audited GAAP Equity Methods

9. The admitted investments in SCA entities shall be recorded using either the market valuation approach (as described in paragraph 9 a.), or one of the equity methods (as described in paragraph 9 b.).

a. In order to use the market valuation approach for SCA entities, the following requirements apply:

i. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;

ii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for its calculation of the subsidiary’s market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;

iii. Ownership percentages for determining the discount rate shall be measured at the holding company level;

iv. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;
v. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;

vi. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required.

vii. Further, the SCA must have at least two million shares outstanding, with a total market value of at least $50 million in the public’s control; and

viii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.

b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 9 a. or, if the requirements are met, but a reporting entity elects not to use that approach, the reporting entity’s proportionate share of its investments in SCAs shall be recorded as follows:

i. Investments in U.S. insurance SCA entities shall be recorded based on the underlying audited statutory equity of the respective entity’s financial statements, adjusted for any unamortized goodwill as provided for in SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68). Reporting entities shall record investments in U.S. insurance SCA entities on at least a quarterly basis, and shall base the investment value on the most recent quarterly information available from the SCA. Entities may recognize their investment in U.S. insurance SCA entities based on the unaudited statutory equity in the SCAs year-end Annual Statement if the annual SCA audit is not complete as of the filing deadline. The recorded statutory equity shall be adjusted for audit adjustments, if any, as soon as the annual audit has been completed. Annual consolidated audits are allowed if completed in accordance with the Model Regulation Requiring Annual Audited Financial Reports as adopted by the SCA’s domiciliary state;

ii. Investments in noninsurance SCA entities that are engaged in the following transactions or activities:

(a) Collection of balances as described in SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

(b) Sale/lease or rental of EDP Equipment and Software as described in SSAP No. 16—Electronic Data Processing Equipment and Software and SSAP No. 79—Depreciation of Nonoperating System Software

(c) Sale/lease or rental of furniture, fixtures, equipment or leasehold improvements as described in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

(d) Loans to employees, agents, brokers, representatives of the reporting entity or SCA as described in SSAP No. 20—Nonadmitted Assets
(e) Sale/lease or rental of automobiles, airplanes and other vehicles as described in SSAP No. 20—Nonadmitted Assets

(f) Providing insurance services on behalf of the reporting entity including but not limited to accounting, actuarial, auditing, data processing, underwriting, collection of premiums, payment of claims and benefits, policyowner services

(g) Acting as an insurance or administrative agent or an agent for a government instrumentality performing an insurance function (e.g. processing of state workers compensations plans, managing assigned risk plans, Medicaid processing etc).

(h) Purchase or securitization of acquisition costs

and if 20% or more of the SCA’s revenue is generated from the reporting entity and its affiliates, then the underlying equity of the respective entity’s audited Generally Accepted Accounting Principles (GAAP) financial statements shall be adjusted to a statutory basis of accounting (refer to paragraph 10). For purposes of this section, revenue means GAAP revenue reported in the audited GAAP financial statements excluding realized and unrealized capital gains/losses. Paragraphs 18 through 20 provide guidance for investments in holding companies;

iii. Investments in noninsurance SCA entities that do not qualify under subparagraph 9 b. ii. shall be recorded based on the audited GAAP equity of the investee;

iv. Investments in foreign insurance SCA entities shall be recorded based on the underlying audited U.S. GAAP equity of the respective entity adjusted to a statutory basis of accounting in accordance with paragraph 10 and adjusted for reserves of the foreign insurance SCA with respect to the business it assumes directly and indirectly from a U.S. insurer using the statutory accounting principles promulgated by the NAIC in the Accounting Practices and Procedures Manual.

The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the annual audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in AICPA Statement of Auditing Standard No. 69, The Meaning of “Presents Fairly in Conformity With GAAP”. Foreign SCA entities are defined as those entities incorporated or otherwise legally formed under the laws of a foreign country. Foreign insurance SCA entities are defined as alien insurers formed according to the legal requirements of a foreign country. Investments in foreign noninsurance SCA entities shall follow the guidance in 8 b. ii., and 8 b. iii. above.

10. Statutory basis for accounting for investments in noninsurance SCA entities, subject to paragraph 9 b. ii. and foreign insurance SCA entities, subject to paragraph 9 b. iv., shall be based on the underlying audited U.S. GAAP equity of the respective entity with the following adjustments:

a. Nonadmit assets pursuant to the following statutory accounting principles as promulgated by the NAIC in the Accounting Practices and Procedures Manual;

i. SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers
ii. **SSAP No. 19**—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

iii. **SSAP No. 20**—Nonadmitted Assets

iv. **SSAP No. 29**—Prepaid Expenses

v. **SSAP No. 16**—Electronic Data Processing Equipment and Software

vi. **SSAP No. 79**—Depreciation of Nonoperating System Software

b. Expense costs that are capitalized in accordance with GAAP but are expensed pursuant to statutory accounting as promulgated by the NAIC in the *Accounting Practices and Procedures Manual* (e.g., deferred policy acquisition costs);

c. Adjust depreciation for certain assets in accordance with the following statutory accounting principles:

i. **SSAP No. 16**—Electronic Data Processing Equipment and Software and **SSAP No. 79**—Depreciation of Nonoperating System Software

ii. **SSAP No. 19**—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

d. Nonadmit the amount of goodwill of the SCA in excess of 10% of the audited GAAP equity of the SCA’s last audited financial statements.

e. Nonadmit amount of the net deferred tax assets (DTAs) of the SCA in excess of 10% of the audited GAAP equity of the SCA’s last audited financial statements.

f. Adjust the GAAP annuity account value reserves of a foreign insurance SCA, with respect to the business it wrote directly, using the commissioners’ annuity reserve valuation method (CARVM) as defined in paragraphs 12 and 13 of Appendix A-820 (including the reserving provisions in the various Actuarial Guidelines which support CARVM). The valuation interest rate and mortality tables to be used in applying CARVM should be that prescribed by the foreign insurance SCA's country of domicile. If the Foreign SCA’s country of domicile does not prescribe the necessary tables and/or rates, no reserve adjustment shall be made.

11. The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in *AICPA Statement of Auditing Standards No. 69, The Meaning of “Presents Fairly in Conformity With GAAP.”* The statutory equity method as described in paragraph 9 b. i., 9 b. ii. and 9 b. iii. shall be applied by recording an initial and subsequent investment in an investee at cost (excluding any investment in an investee’s surplus notes), which is defined in SSAP No. 68 as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. After the date of acquisition, the investment amount shall be adjusted for the amortization of goodwill and the reporting entity’s share of the change in special surplus funds, other than special surplus funds and unassigned funds (surplus), as defined in **SSAP No. 72**—*Surplus and Quasi-reorganizations*. This represents the carrying amount of the investment.
12. Once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity may not change the valuation method to another method without the approval of the domiciliary commissioner. For instance, if an entity selects the market valuation method, it may not change to an equity method or vice versa without approval from the domiciliary commissioner. The only exception to this notification requirement is the case in which an investment in a SCA entity that was previously accounted for under one method no longer qualifies under that method because of a change in the level of ownership, (i.e., acquisition of additional interests by the reporting entity) acquisition or retirement of interests by the investee, or a change in facts or circumstances (e.g., paragraphs 9 a. i., 9 a. vii.). Further, in order for an entity to transfer from a paragraph 9 a., 9 b. ii. or 9 b. iii. valuation to a paragraph 9 b. iv. valuation, the SCA shall not exceed the 20% threshold (as defined in paragraphs 9 a. ii. and 9 b. iii.) for three consecutive years. When an investment qualifies for use of another method of accounting, the reporting entity shall adopt the new method of accounting and the investment shall be adjusted to reflect the reporting entity’s equity interest in the SCA entity under the new method. A corresponding amount shall be recorded as an unrealized gain or loss.

13. If the reporting entity is using an equity method, the reporting entity’s share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity’s share of other changes in the investee’s surplus (e.g., the change in the investee’s nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. If the reporting entity uses the market valuation approach outlined in paragraph 9 a., changes in that valuation shall be included in unrealized gains and losses. Dividends or distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Dividends or distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

14. For investments in entities recorded based on the underlying audited GAAP equity of the investee, the amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in SSAP No. 68). The carrying amount of the investment shall be adjusted to recognize the reporting entity’s share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity’s share of adjustments that are recorded directly to the investee’s stockholder’s equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded directly to unrealized capital gains and losses on investments.

15. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 9 b. i. through 9 b. iv.), as applicable, to investments in SCA entities:

a. A difference between the cost of an investment and the underlying equity in the statutory or GAAP book value, as applicable, of the acquired company at the date of acquisition shall be accounted for in accordance with SSAP No. 68;

b. A transaction of an investee of a capital nature that affects the reporting entity’s share of stockholders’ equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity’s equity ownership in the investee, the reporting entity’s recorded investment shall be adjusted to reflect the transaction);

c. Realized gains or losses on the sale of an investment in a SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss;
d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee’s current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period;

e. A reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee’s preferred dividends, whether or not such dividends are declared;

g. An investment in a SCA entity may fall below the level of ownership described in paragraph 6 from the sale of a portion of an investment by the reporting entity, the sale of additional interests by an investee, or other transactions. The reporting entity shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for an equity method. The earnings or losses that relate to the investment interests retained by the reporting entity and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed the reporting entity’s share of earnings for such periods shall be applied as a reduction of the carrying amount of the investment.

16. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a downstream SCA entity, the directly held entity, which owns the parent’s shares, shall have its value reduced for the reciprocal ownership.

17. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a 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.

Investments in Holding Companies

18. Valuation of a holding company depends upon the nature of the SCA entities it holds in accordance with paragraph 9 and the guidance contained in the applicable SSAP for non-SCA investments. If an SCA investment of the holding company does not meet the provisions of paragraph 9. a. or if it elects not to use the guidance in paragraph 9 a., and instead uses the guidance in paragraph 9. b., then the holding company would look to its underlying assets and record them as follows:

a. Investments by a holding company in insurance SCA entities are recorded based upon the guidance in paragraph 9 b. i.;
b. Investments by a holding company in noninsurance SCA entities that primarily provide services or hold assets that are for the direct or indirect use of the reporting entity or its affiliates are recorded based upon the guidance in paragraph 9 b. ii. or 9 b. iii. as applicable;

c. Investments by a holding company in noninsurance SCA entities that do not qualify under paragraph 18 b. above shall be recorded based upon the guidance in paragraph 9 b. iii.; and

d. Investments by a holding company in foreign insurance and noninsurance SCA entities shall be recorded based upon the guidance in paragraphs 9 b. iv. above.

19. In lieu of separate GAAP audits of SCA entities of the holding company, the insurer can choose to have a GAAP audit performed at the holding company level with a consolidating balance sheet showing GAAP equity of all the SCA entities. The consolidating balance sheet shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 9 b. ii. 9 b. iii. and 9 b. iv. entities under the holding company. This adjusted amount would then be the reported value of the investment in holding company at the higher level insurance company.

20. A purchased holding company is valued in accordance with the provisions above and the provisions of SSAP No. 68.

**Investment in Preferred Stock or Surplus Notes of a Subsidiary, Controlled and Affiliated Entity**

21. When the reporting entity also holds an investment in preferred stock or surplus note(s) of an SCA and the carrying amount determined in accordance with paragraphs 9 b. and 10 includes preferred stock or surplus note(s), the investment in the SCA must be separated into its components. The carrying amount of the SCA is reduced by the value of the SCA’s preferred stock or surplus note(s).

22. Investments in the preferred stock of an SCA shall be accounted for and reported in accordance with the provisions of **SSAP No. 32—Investments in Preferred Stock** (SSAP No. 32). This statement amends the title of SSAP No. 32 as follows:

**SSAP No. 32—Investments in Preferred Stock** *(including excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)*

This statement amends paragraphs 2 and 3 of SSAP No. 32 to the following:

2. Investments in preferred stock of subsidiaries, controlled or affiliated entities are included within the scope of this statement.

3. Preferred stock (including investment in affiliates), which may or may not be publicly traded and may include shares against which exchange traded call options are outstanding, shall include:

23. Investments in the surplus notes of an SCA shall be accounted for and reported in accordance with the provisions of **SSAP No. 41—Surplus Notes**.

24. The following example is provided to illustrate the accounting and reporting. The reporting entity holds 100% of the preferred stock. The SCA issued the preferred stock for $50,000. The investment in the SCA, measured in accordance with this SSAP is $250,000 including the preferred stock of the SCA. The investment in the SCA is $200,000 ($250,000-50,000) and the preferred stock is measured and reported in accordance with SSAP No. 32.
Impairment

25. When there is a decline in the fair value of an asset owned by a SCA entity that is other than temporary, the SCA entity shall write the asset down to fair value.

26. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings, which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Consolidation

27. Majority-owned subsidiaries shall not be consolidated for individual entity statutory reporting. This does not exempt certain reporting entities that are members of an affiliated group from the requirement to issue consolidated or combined annual statements as supplemental information in accordance with NAIC guidelines.

Disclosures

28. The significance of an investment to the reporting entity’s financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

   a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, market value or discounted market value adjustments) and the accounting treatment of the difference;

   b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted market price and the difference, if any, between the amount at which the investment is carried and the quoted market price shall be disclosed;

   c. Summarized information as to assets, liabilities, and results of operations shall be presented for SCA entities, either individually or in groups;

   d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor’s share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity; and
e. For those SCA entities in which the reporting entity elected, or was required to change its valuation method as described in paragraph 12, a description of the reason for the change and the amount of adjustment recorded as unrealized gains or losses shall be disclosed. The entity shall also disclose whether commissioner approval was obtained in accordance with paragraph 12.

29. Any commitment or contingent commitment to a SCA entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

30. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write down:

   a. A description of the impaired assets and the facts and circumstances leading to the impairment; and
   
   b. The amount of the impairment and how fair value was determined.

31. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 28 d. above shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

32. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2004.

DISCUSSION

33. This issue paper replaces the conclusions reached in SSAP No. 46. The amendments to SSAP No. 46 included in this issue paper are considered substantive by the Statutory Accounting Principles Working Group as they replace the judgment in determining application of statutory equity method versus the audited GAAP equity with a specific “bright-line” test. The following represents the substantive changes from SSAP No. 46 that are included in this issue paper:
This issue paper nullifies the following interpretations of the Emerging Accounting Issues Working Group:

a. *INT 99-03: Accounting for Investment in Subsidiary, Controlled or Affiliated Entities with Subsequent Downstream Investment in an Insurance Company* is nullified because INT 01-06 provided for a more descriptive application for holding companies. As this issue paper incorporates the guidance in INT 01-06, the conclusions reached in INT 99-3 are no longer necessary.

b. *INT 99-28: Accounting for SCA Mutual Funds, Broker-Dealers and Similar Entities Under SSAP No. 46* is nullified because there is no longer a need to differentiate certain SCA investments as the term “significant operations” has now been defined.

c. *INT 00-01: Investment in a Foreign SCA Entity* is nullified by the conclusions reached in paragraph 9 b. iv.

d. *INT 01-24: Application of SSAP No. 46 and 48 to Certain Noninsurance Subsidiary, Controlled or Affiliated Entities* is nullified by the conclusions reached in paragraph 9 and Exhibit A.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**
35. See Issue Paper No. 46 for statutory references.

**Generally Accepted Accounting Principles**

36. See Issue Paper No. 46 for GAAP references.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 46—Investments in Subsidiary, Controlled and Affiliated Entities

**Generally Accepted Accounting Principles**
- See Issue Paper No. 46 for GAAP references.

**State Regulations**
- No additional guidance obtained from state statutes or regulations
EXHIBIT A – ILLUSTRATIVE EXAMPLES FOR PROVISION OF PARAGRAPH 9 b.

Example 1:
Insurance Company A owns 100% of a third party administrator, TPA1. TPA1 processes claims for noninsurance companies and for Medicare and Medicaid programs. TPA1 is completely independent from Insurance Company A and as such does not receive any management income or lease income from Insurance Company A or its affiliates. TPA1 does not process claims for Insurance Company A.

Equity Method – Insurance Company A would value TPA1 under 9 b. iii. (audited GAAP equity) as TPA1’s revenue from Insurance Company A is less than 20%.

Example 2:
Insurance Company A owns 100% of a company that processes insurance claims, TPA2. TPA2 processes claims for Insurance Company A, Insurance Company B, Insurance Company C and Insurance Company D. TPA2 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Companies B, C and D are not affiliates of Insurance Company A. The processing of claims for Insurance Company A constitutes 15% of the revenues of TPA2.

Equity Method – Insurance Company A would value TPA2 under 9 b. iii. (audited GAAP equity) as TPA2’s revenue from Insurance Company A is less than 20%.

Example 3:
Insurance Companies A, B, C and D each own 25% of a company, TPA3, that provides administrative services, including all EDP processing, to Insurance Companies A, B, C and D. TPA3 owns the EDP equipment and software and furniture, fixtures and equipment necessary to provide administrative services to its customers. TPA3 does not provide administrative services to any other entities. Insurance Companies A, B, C and D are not part of the same insurance holding company system. The processing that TPA3 does for each of Insurance Companies A, B, C and D constitutes 25% of its business and revenues.

Equity Method – Insurance Company A, B, C and D would value TPA3 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA3’s revenue from each Insurance Company A, B, C and D is greater than 20%.

Example 4:
Insurance Company A owns 100% of a company, TPA4, that provides administrative services, including EDP processing, to Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D. TPA4 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D are not affiliates, i.e. none of the four companies are related to one another. The processing that TPA4 does for Insurance Company A represents 40% of TPA4’s business and revenues.

Equity Method – Insurance Company A would value TPA4 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA4’s revenue from Insurance Company A is greater than 20%.

Example 5:
Insurance Company A owns 100% of a company, TPA5, that provides claims administration services, including EDP processing, to Insurance Company A, Insurance Company B, numerous self-insured companies and Medicare. TPA5 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B and the self-insured companies are not affiliates, i.e., they are not related to one another. Insurance Companies A and B may provide stop-loss coverage to some of the self-insured companies for whom TPA5 provides claims.
administration services. The processing that TPA5 does for Insurance Company A represents 51% of TPA5’s business and revenues.

Equity Method – Insurance Company A would value TPA5 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA4’s revenue from Insurance Company A is greater than 20%.

Example 6:
Insurance Company A holds an 18.77% Partnership Interest in LPA. This fund was organized for the primary purpose of investing in investment vehicles and commodity pools as a “fund of funds” investment manager. The insurer is a limited partner. The general partner is not affiliated with the insurer. Quoting from the limited partnership agreement Section 3.1 – “The general partner shall be vested with the complete control of the business of the fund. The limited partners shall have no responsibility for the management of the fund and shall have no authority or right to act on behalf of the fund or to bind the fund in connection with any matter.” The largest holding on their 12/31/99 audited GAAP financials was $293.6 million of “Investments in limited partnerships and investment funds, at fair value.” Beyond that they have $28.0 million of cash and cash equivalents and $90k of dividends and interest receivable.

Equity Method – Insurance Company A would value LPA under 9 b. iii. (audited GAAP equity) as less than 20% of LPA’s investment income is for the benefit of Insurance Company A.

Example 7:
Insurance Company A holds a 25% Partnership Interest in LPB. Similar to the LPA above, LPB is another limited partnership investment where the insurer owns greater than a 10% interest. The LP fund was organized primarily for the purpose of making investments in media businesses. The fund’s general partner is not affiliated with the insurer. The general partner manages all of the affairs of the Fund, i.e., controls the business activities of the fund. The largest holding on their 12/31/99 unaudited GAAP financials (assume for this example that audited statements are not and will not be prepared) was $194.0 million of “Portfolio investments at fair value.” This was made up of a combination of partnership and stock investments. Total assets were $200.8 million at 12/31/99.

Equity Method – Insurance Company A would value LPB under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as more than 20% of the investment income of LPB is for the benefit of Insurance Company A.

Example 8:
Insurance Company A holds a 25% Partnership Interest in LLP. LLP is a real estate development limited partnership in which the insurer holds a 25% interest as a limited partner. The LLP’s general partner is not affiliated with the insurer. The general partner manages the affairs of partnership including decisions on properties to acquire and/or develop. Assets of the partnership include real estate properties, both residential and commercial. Total assets of the partnership are $1 billion and total liabilities $500 million, primarily outside debt. LLP prepares annual audited GAAP financial statements, however, they are not completed prior to the insurer filing its annual financial statements.

Equity Method – Insurance Company A would value LLP under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as more than 20% of the investment income of LLP is for the benefit of Insurance Company A.
Statutory Issue Paper No. 119

Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82

STATUS
Finalized June 10, 2002

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish a statutory capitalization policy that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. This issue paper amends certain conclusions reached in SSAP No. 4–Assets and Nonadmitted Assets (SSAP No. 4), SSAP No. 19–Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements (SSAP No. 19), SSAP No. 29–Prepaid Expenses (SSAP No. 29), SSAP No. 73–Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities (SSAP No. 73), SSAP No. 79–Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16–Electronic Data Processing Equipment and Software (SSAP No. 79) and SSAP No. 82–Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs (SSAP No. 82).

RECOMMENDED CONCLUSION

3. In general, this issue paper amends the phrase “in accordance with the reporting entity's capitalization policy, immaterial amounts … can be expensed …” to “in accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold … shall be expensed …”. A predefined threshold shall be established, for each asset class identified by SSAP Nos. 19, 29, 73, 79 and 82, by management based upon an analysis of circumstances unique to the entity and shall not be adjusted from period to period except under extenuating circumstances. If an entity demonstrates a pattern of varying its capitalization policy from period to period without sufficient evidence as determined by the reporting entity’s domestic regulator, such action would call into question both the entity’s ability to accurately establish a predefined threshold and the propriety of expensing or capitalizing certain assets. Accordingly, entities shall expense all immaterial amounts (i.e., entity is no longer allowed to establish its own capitalization policy).

4. This issue paper amends paragraph 3 of SSAP No. 4 to the following:

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

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

5. This issue paper amends paragraphs 3 and 6 of SSAP No. 19 to the following:

In accordance with the reporting entity's capitalization policy, amounts less than a predefined threshold of such assets shall be expensed when purchased.

6. This issue paper amends paragraph 3 of SSAP No. 29 to the following:

In accordance with the reporting entity's capitalization policy, prepaid expenses less than a predefined threshold shall be expensed when purchased.

7. This issue paper amends paragraph 10 of SSAP No. 73 to the following:

In accordance with the reporting entity's capitalization policy, amounts less than a predefined threshold of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements shall be expensed when purchased.

8. This issue paper amends paragraph 4 of SSAP No. 79 to the following:

In accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold shall be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

9. This issue paper amends paragraph 4 of SSAP No. 82 to the following:

In accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold of such costs shall be expensed when incurred.

10. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Disclosures

11. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

Effective Date and Transition

12. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the
Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2004.

DISCUSSION

13. This issue paper replaces the subjectivity associated with capitalizing assets based upon materiality with a more quantifiable concept of capitalizing assets above a predefined threshold. This amendment is in harmony with the principle of consistency found in the Statement of Concepts. That is, the concept of materiality used in previous SSAPs was subject to interpretation and manipulation from period to period whereas the predefined threshold model used in this issue paper provides a definitive benchmark that can be quantified and judged from period to period. This issue paper requires entities to disclose their threshold, explain how they reached their threshold and offer support if they modify their capitalization policy. Previous statements, due to the subjective nature of expensing immaterial amounts, did not require this disclosure. The issue paper also includes a penalty for entities that manipulate their capitalization policy from period to period. The NAIC believe this issue paper provides a more consistent and transparent capitalization framework than previous statements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

14. SSAP No. 4 paragraph 3:

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

   a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or

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

15. SSAP No. 19 paragraphs 3 and 6:

3. In accordance with the reporting entity's capitalization policy, immaterial amounts of such assets can be expensed when purchased.

6. In accordance with the reporting entity's capitalization policy, immaterial amounts of such assets can be expensed when acquired.

16. SSAP No. 29 paragraph 3:

3. In accordance with the reporting entity's capitalization policy, immaterial prepaid expenses may be expensed when purchased.
17. SSAP No. 73 paragraph 10:

10. In accordance with the reporting entity's capitalization policy, immaterial amounts of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements may be expensed when purchased.

18. SSAP No. 79 paragraph 4:

4. In accordance with the reporting entity's capitalization policy, immaterial amounts may be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

19. SSAP No. 82 paragraph 4:

4. In accordance with the reporting entity's capitalization policy, immaterial amounts of such costs can be expensed when incurred.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 4–Assets and Nonadmitted Assets
- SSAP No. 19–Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements
- SSAP No. 29–Prepaid Expenses
- SSAP No. 73–Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities
- SSAP No. 79–Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16–Electronic Data Processing Equipment and Software
- SSAP No. 82–Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs

Generally Accepted Accounting Principles

- No guidance obtained from GAAP
EXHIBIT A: Illustration of Marked Changes to Amended SSAPs

The following depicts the amendments made by this issue paper as “marked changes” (new text underlined and deleted text struck-through):

SSAP No. 4 paragraph 3:

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

a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


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

SSAP No. 19 paragraphs 3 and 6:

3. In accordance with the reporting entity's capitalization policy, immaterial amounts less than a predefined threshold of such assets can shall be expensed when purchased.

6. In accordance with the reporting entity's capitalization policy, immaterial amounts less than a predefined threshold of such assets can shall be expensed when purchased.

SSAP No. 29 paragraph 3:

3. In accordance with the reporting entity's capitalization policy, immaterial prepaid expenses less than a predefined threshold shall may be expensed when purchased.

SSAP No. 73 paragraph 10:

10. In accordance with the reporting entity's capitalization policy, immaterial amounts less than a predefined threshold of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements may shall be expensed when purchased.
SSAP No. 79 paragraph 4:

4. In accordance with the reporting entity’s capitalization policy, immaterial amounts less than a predefined threshold shall be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

SSAP No. 82 paragraph 4:

4. In accordance with the reporting entity’s capitalization policy, immaterial amounts less than a predefined threshold of such costs shall be expensed when incurred.
Statutory Issue Paper No. 121

Accounting for the Impairment or Disposal of Real Estate Investments

STATUS:
Finalized March 15, 2004

Type of Issue:
Common Area

SUMMARY OF ISSUE


2. Generally Accepted Accounting Principles (GAAP) guidance for these issues was previously found in Financial Accounting Standards Board (FASB) Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (FAS 121) and Accounting Principles Board (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 (APB 30). FAS 121 was superseded by FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144). APB 30 was superseded in part by FAS 144.

3. This issue paper establishes statutory accounting principles for the impairment or disposal of real estate investments and the treatment of long-lived assets associated with discontinued operations including nonadmitted intangible assets other than goodwill, such as trade names (referred to collectively as long-lived assets). This statement is not intended to conflict with guidance concerning operating results associated with discontinued operations, which is contained in SSAP No. 24.

4. This issue paper supersedes SSAP No. 40, paragraphs 9, 10 and 19.

5. This issue paper does not apply to (a) goodwill, (b) servicing assets, (c) financial instruments, including investments in equity securities accounted for under the cost or equity method, (d) deferred policy acquisition costs, and (e) deferred tax assets. This issue paper also does not apply to long-lived assets for which the accounting is prescribed by FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed as adopted with modification to preclude the capitalization of software development costs in SSAP No. 17—Preoperating and Research and Development Costs. For a discussion on software development costs, see the guidance in SSAP No. 82—Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs. Statutory guidance on goodwill is in SSAP No. 68.

RECOMMENDED CONCLUSION

Recognition and Measurement of an Impairment Loss

6. For purposes of this Statement, impairment is the condition that exists when the carrying amount of a long-lived asset exceeds its fair value. An impairment loss shall be recognized only if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from
the use and eventual disposition of the asset. That assessment shall be based on the carrying amount of the asset at the date it is tested for recoverability, whether in use or under development. An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

When to Test a Long-Lived Asset for Recoverability

7. A long-lived asset shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

a. A significant decrease in the market price of a long-lived asset

b. A significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived 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 the use of a long-lived asset

f. A current expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

8. When a long-lived asset is tested for recoverability, it also may be necessary to review depreciation estimates and methods as required by SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3). Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset for recoverability. However, any change in the accounting method for the asset resulting from that review shall be made only after applying this Statement.

Grouping Long-Lived Assets to Be Held and Used

9. For purposes of recognition and measurement of an impairment loss, a long-lived asset or assets shall not be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities for properties occupied by the company.

10. In limited circumstances, a long-lived asset (for example, a corporate headquarters facility) may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and of other asset groups that consist of properties occupied by the company. In those circumstances, the asset group for that asset shall include all assets and liabilities of the entity.

New Cost Basis

11. If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset shall be its new cost basis. For a depreciable long-lived asset, the new cost basis shall be depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.
Estimates of Future Cash Flows Used to Test a Long-Lived Asset for Recoverability

12. Estimates of future cash flows used to test the recoverability of a long-lived asset shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with, and that are expected to arise as a direct result of, the use and eventual disposition of the asset. Those estimates shall exclude interest charges that will be recognized as an expense when incurred.

13. Estimates of future cash flows used to test the recoverability of a long-lived asset shall incorporate the entity’s own assumptions about its use of the asset and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others. However, if alternative courses of action to recover the carrying amount of a long-lived asset are under consideration or if a range is estimated for the amount of possible future cash flows associated with the likely course of action, reporting entities shall use their best estimate in testing the recoverability of a long-lived asset.

14. Estimates of future cash flows used to test the recoverability of a long-lived asset shall be made for the remaining useful life of the asset to the entity.

15. Estimates of future cash flows used to test the recoverability of a long-lived asset that is in use, including a long-lived asset for which development is substantially complete, shall be based on the existing service potential of the asset at the date it is tested. The service potential of a long-lived asset encompasses its remaining useful life, cash-flow-generating capacity, and for tangible assets, physical output capacity. Those estimates shall include cash flows associated with future expenditures necessary to maintain the existing service potential of a long-lived asset, including those that replace the service potential of component parts of a long-lived asset (for example, the roof of a building) and component assets other than the primary asset of an asset group. Those estimates shall exclude cash flows associated with future capital expenditures that would increase the service potential of a long-lived asset.

16. Estimates of future cash flows used to test the recoverability of a long-lived asset that is under development shall be based on the expected service potential of the asset when development is substantially complete. Those estimates shall include cash flows associated with all future expenditures necessary to develop a long-lived asset, including interest payments that will be capitalized as part of the cost of the asset.

17. If a long-lived asset that is under development is part of an asset group that is in use, estimates of future cash flows used to test the recoverability of that group shall include the cash flows associated with future expenditures necessary to maintain the existing service potential of the group as well as the cash flows associated with all future expenditures necessary to substantially complete the asset that is under development.

Fair Value

18. A discussion of fair value is contained in the Glossary to the Statements of Statutory Accounting Principles. This issue paper requires properties occupied by the company, that are determined to be subject to recoverability testing as discussed in paragraphs 7 and 8, to follow the guidance in SSAP No. 40, paragraph 11.

Real Estate Investment Categories

19. SSAP No. 40 states that real estate investments shall be reported in the balance sheet categories of properties occupied by the company, properties held for the production of income, and properties held
for sale. However, the accounting guidance in FAS 144 distinguishes between long-lived assets to be held and used and long-lived assets to be disposed of. For statutory accounting purposes, long-lived assets to be held and used encompass properties occupied by the company and properties held for the production of income. Further, FAS 144 bifurcates the category of long-lived assets to be disposed of into long-lived assets to be disposed of other than by sale and long-lived assets to be disposed of by sale. Long-lived assets to be disposed of other than by sale shall be classified either as properties occupied by the company or as properties held for the production of income. Long-lived assets to be disposed of by sale shall be classified as properties held for sale.

Long-Lived Assets to Be Disposed Of Other Than by Sale

20. A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange for a similar productive long-lived asset, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until disposal. Paragraphs 6 through 19 shall apply while the asset is classified as held and used. If a long-lived asset is to be abandoned or distributed to owners in a spinoff together with other assets (and liabilities) as a group and that disposal group is a segment, paragraph 33 shall apply to the disposal group at the date of disposal.

Long-Lived Asset to Be Abandoned

21. For purposes of this Statement, a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with SSAP No. 3 to reflect the use of the asset over its shortened useful life. A long-lived asset that has been temporarily idled shall not be accounted for as if abandoned.

Long-Lived Asset to Be Exchanged for a Similarly Productive Long-Lived Asset or to Be Distributed to Owners in a Spinoff

22. For purposes of this Statement, a long-lived asset to be exchanged for a similarly productive long-lived asset or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset exceeds its fair value.

Long-Lived Assets to Be Disposed Of by Sale

Recognition

23. A long-lived asset to be sold shall be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset;

b. The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets;

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated;
d. The sale of the asset is probable, and transfer of the asset is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 24;

e. The asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value;

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If at any time the criteria in this paragraph are no longer met (except as permitted by paragraph 24), a long-lived asset classified as held for sale shall be reclassified as held and used in accordance with paragraphs 31 and 32.

24. Events or circumstances beyond an entity’s control may extend the period required to complete the sale of a long-lived asset beyond one year. An exception to the one-year requirement in paragraph 23(d) shall apply in the following situations in which such events or circumstances arise:

a. If at the date an entity commits to a plan to sell a long-lived asset the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset that will extend the period required to complete the sale and (1) actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained and (2) a firm purchase commitment is probable within one year.

b. If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a long-lived asset previously classified as held for sale that will extend the period required to complete the sale and (1) actions necessary to respond to the conditions have been or will be initiated in a timely manner and (2) a favorable resolution of the delaying factors is expected.

c. If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset previously classified as held for sale is not sold by the end of that period and (1) during the initial one-year period the entity initiated actions necessary to respond to the change in circumstances, (2) the asset is being actively marketed at a price that is reasonable given the change in circumstances, and (3) the criteria in paragraph 23 are met.

25. A long-lived asset that is newly acquired and that will be sold rather than held and used shall be classified as held for sale at the acquisition date only if the one-year requirement in paragraph 23(d) is met (except as permitted by paragraph 24) and any other criteria in paragraph 23 that are not met at that date are probable of being met within a short period following the acquisition (usually within three months).

26. If the criteria in paragraph 23 are met after the balance sheet date but before issuance of the financial statements, a long-lived asset shall continue to be classified as held and used in those financial statements when issued. The information required by paragraph 39 shall be disclosed in the notes to the financial statements. If the asset is tested for recoverability (on a held-and-used basis) as of the balance sheet date, the estimates of future cash flows used in that test shall consider the likelihood of possible outcomes that existed at the balance sheet date, including the assessment of the likelihood of the future sale of the asset. That assessment made as of the balance sheet date shall not be revised for a decision to sell the asset after the balance sheet date. An impairment loss, if any, to be recognized shall be measured as the amount by which the carrying amount of the asset exceeds its fair value at the balance sheet date.
### Measurement

27. A long-lived asset classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell. If the asset is newly acquired, the carrying amount of the asset shall be established based on its fair value less cost to sell at the acquisition date. A long-lived asset shall not be depreciated (amortized) while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal classified as held for sale shall continue to be accrued.

28. Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made. Those costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Those costs exclude expected future losses associated with the operations of a long-lived asset while it is classified as held for sale.

29. The carrying amounts of any assets that are not covered by this Statement that are included in a disposal classified as held for sale shall be adjusted in accordance with other applicable statements of statutory accounting principles prior to measurement.

30. A realized loss shall be recognized in the summary of operations for any initial or subsequent write-down to fair value less cost to sell. A gain shall not be recognized for any subsequent increase in fair value less cost to sell until the asset is sold. The loss shall adjust only the carrying amount of a long-lived asset, whether classified as held for sale individually or as part of a disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset shall be recognized at the date of sale.

### Changes to a Plan of Sale

31. If circumstances arise that previously were considered unlikely and, as a result, an entity decides not to sell a long-lived asset previously classified as held for sale, the asset shall be reclassified as held and used. A long-lived asset that is reclassified shall be measured individually at the lower of its (a) carrying amount before the asset was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset been continuously classified as held and used, or (b) fair value at the date of the subsequent decision not to sell.

32. Any required adjustment to the carrying amount of a long-lived asset that is reclassified as held and used shall be included in income from operations in the period of the subsequent decision not to sell. That adjustment shall be reported in the same income statement caption used to report a loss, if any, recognized in accordance with paragraph 34.

### Reporting Long-Lived Assets and Disposal Groups to Be Disposed Of

**Reporting Discontinued Operations**

33. For purposes of reporting income and losses related to discontinued operations; any reference to the phrase “component of an entity” is replaced with “segment” as defined in SSAP No. 24.

**Reporting Disposal Gains or Losses in Operations**

34. Any disposal gain or loss recognized for long-lived assets shall be included as a net realized gain or loss in the summary of operations.
Reporting a Long-Lived Asset or Disposal Group Classified as Held for Sale

35. A long-lived asset classified as held for sale shall be presented separately in the balance sheet. The assets and liabilities of a disposal classified as held for sale shall be presented separately in the asset and liability sections, respectively, of the balance sheet. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the balance sheet or in the notes to financial statements (paragraph 39).

Reporting Impairment

36. Any impairment loss recognized on long-lived assets shall be recorded in the summary of operations as a realized loss.

Disclosures

37. The following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

   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; and

38. The caption in the summary of operations, which includes the impairment loss.

39. The following information shall be disclosed in the notes to the financial statements that cover the period in which a long-lived asset either has been sold or is classified as held for sale:

   a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal.
   b. If applicable, the gain or loss recognized and if not separately presented on the face of the summary of operations, the caption in the summary of operations that includes that gain or loss.

40. If paragraphs 31 and 32 apply, a description of the facts and circumstances leading to the decision to change the plan to sell the asset; and its effect on the results of operations for the period and any prior periods presented shall be disclosed in the notes to financial statements that include the period of that decision.

Effective Date and Transition

41. Upon adoption of this issue paper, the NAIC will release a SSAP for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2004.
DISCUSSION

42. FAS 144 supersedes FAS 121 and in part APB 30. FAS 144 retains the requirements of FAS 121 to (a) recognize an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and (b) measure an impairment loss as the difference between the carrying amount and fair value of the asset. FAS 144 requires that a long-lived asset to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spinoff be considered held and used until it is disposed of. FAS 144 also sets forth that the accounting model for long-lived assets to be disposed of by sale is used for all long-lived assets, whether previously held and used or newly acquired. FAS 144 also resolves implementation issues that came about in the application of existing guidance.

43. SSAP No. 40 states that real estate investments shall be reported in the balance sheet categories of properties occupied by the company, properties held for the production of income, and properties held for sale. However, the accounting guidance in FAS 144 distinguishes between long-lived assets to be held and used and long-lived assets to be disposed of. For statutory accounting purposes, long-lived assets to be held and used encompass properties occupied by the company and properties held for the production of income and will be referred to as such in this issue paper. Further, FAS 144 bifurcates the category of long-lived assets to be disposed of into long-lived assets to be disposed of other than by sale and long-lived assets to be disposed of by sale. In this issue paper, long-lived assets to be disposed of other than by sale shall be classified either as properties occupied by the company or as properties held for the production of income, as set forth in paragraph 27 of FAS 144 which is adopted in this issue paper. Long-lived assets to be disposed of by sale shall be classified as properties held for sale.

44. FAS 144 contains substantial guidance concerning the concept of grouping of assets for the purposes of measurement of an impairment loss. Grouping would seem to allow for the offsetting of gains on certain assets with losses on other assets in the same grouping, possibly resulting in no impairment loss being recognized. This is contrary to the concept of conservatism in the Statement of Concepts. As such, grouping of assets for the purpose of determining whether an impairment loss has occurred will not be allowed for statutory accounting purposes.

45. During the drafting process of this issue paper, an initial determination was made that SSAP Nos. 24, 40, 68 would be amended as a result of adopting FAS 144. Ultimately, only SSAP No. 40 was amended relative to adoption of FAS 144 as discussed below.

46. This issue paper adopts FAS 144 with modification to paragraphs 9, 17, 18, 19, 21, 25, 28, 35, 36, 37, 41, 42, 44, 45 and 47. Further, this issue paper rejects paragraphs 10 through 14, paragraphs 22 through 24, 26d, and 43 of FAS 144. Refer to paragraph 47 of this issue paper for additional information with regard to these paragraphs.

47. The following modifications to FAS 144 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts:

   a. Paragraph 9 is amended to require that changes in depreciation estimates and methods and amortization periods found as a result of a test for recoverability should be accounted for in accordance with SSAP No. 3;

   b. Paragraphs 10 through 14, which address the grouping of assets, are rejected, as reporting entities should apply the guidance in this statement to each of its assets on an individual basis;

   c. Paragraphs 17, 18, 19 and 21 discuss estimates of future cash flows used to test the recoverability of a long-lived asset, and states that a probability-weighted approach may be useful in considering the likelihood of those possible outcomes. For statutory
accounting purposes, reporting entities shall use their best estimate in testing the recoverability of a long-lived asset;

d. Paragraphs 22 through 24, which discuss fair value, are rejected. The definition of fair value is in the glossary to the Statement of Statutory Accounting Principles. In addition, this statement allows a modification to use for determining the fair value of properties occupied by company.

e. Paragraph 25 is amended to require that an impairment loss on properties occupied by the company and properties held for the production of income shall be recorded in the summary of operations as a realized loss;

f. Paragraph 28 is amended to require that changes in depreciation estimates shall be accounted for in accordance with SSAP No. 3;

g. If the sale is expected to occur beyond one year, paragraph 35 allows the cost to sell to be discounted. For statutory accounting purposes, the cost to sell shall not be discounted;

h. Paragraph 36 is amended to remove the reference to goodwill, as FAS 144 does not include goodwill within its scope unless such goodwill is included in an asset group that is or includes a reporting unit; paragraph 18 of this issue paper does not recognize a reporting unit. Paragraph 36 is further amended to require reporting entities to adjust all assets in accordance with other applicable statements of statutory accounting principles prior to measurement;

i. Paragraph 37 is amended to clarify that losses recognized as a result of adjustments to fair value less cost to sell shall be recorded in the summary of operations as a realized gain/loss. Paragraph 37 is also modified to disallow the recognition of any gain for subsequent increases in fair value less cost to sell until the asset is sold. This is consistent with the concept of conservatism found in the Statement of Concepts;

j. Within paragraphs 41, 42 and 44 of FAS 144 addressing discontinued operations, any reference to the phrase “component of an entity” is replaced with “segment” as defined in SSAP No. 24;

k. Paragraph 42 is amended to state that the results of operations of a discontinued operation shall be reported consistently with the entity’s reporting of continuing operations. This is consistent with the guidance found in paragraph 5 of SSAP No. 24;

l. Paragraph 44 is amended to state that adjustments to amounts previously reported related to continuing operations shall be reported consistently with the entity’s reporting of continuing operations. This is consistent with the guidance found in paragraph 5 of SSAP No. 24. In addition, subparagraphs a through c of paragraph 44 are adopted into paragraph 5 of SSAP No. 24;

m. Paragraph 45 is amended to state that a gain or loss on an asset classified as held for sale that has been disposed of shall be included in the summary of operations as a realized gain or loss;

n. The disclosures in paragraphs 47a and 47b are adopted with respect to properties held for sale, except for the disclosures related to major classes of assets, as grouping has been rejected in this issue paper. Subparagraphs 47c and 47d are rejected as such paragraphs relate to discontinued operations and segment reporting. The disclosures included in
paragraphs 6 and 7 of SSAP No. 24 are more appropriate given the differences between statutory and GAAP reporting of discontinued operations;

o. Paragraph 26d requires the disclosure of the segment in which an impaired asset is reported. This paragraph is rejected, as statutory accounting requires accounting and reporting at the legal entity level. Further, any additional references to segments, reporting units, or disposal groups found in FAS 144 are also rejected, except with regard to a segment within the context of discontinued operations; and

p. Paragraph 43 is rejected and the guidance related to the recognition of losses/income expected between the measurement date and the expected disposal date included in paragraph 4 of SSAP No. 24 is retained, as such guidance is consistent with the concept of conservatism in the Statement of Concepts.

48. Paragraphs 12 through 14 of FAS 121 address the impairment of goodwill, and paragraphs 12, 14a and 14b of FAS 121 were adopted in SSAP No. 68. However, paragraph 12 of FAS 121 was superseded by FASB Statement No. 142, Goodwill and Other Intangible Assets (FAS 142), which was rejected in SSAP No. 68. Given the applicability of the guidance found in paragraph 12 of FAS 121 to statutory accounting principles, the impairment guidance found in FAS 121, paragraph 12 is retained. Paragraph 12 of FAS 121 has been excerpted in Issue Paper No. 68—Business Combinations and Goodwill, paragraph 31.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

49. SSAP No. 40 paragraphs 4, 8, 9, 10, 11, and 19:

7. Real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of related encumbrances:

   a. Properties occupied by the company;

   b. Properties held for the production of income; and

   c. Properties held for sale.

8. 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.

9. Properties occupied by the company 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 FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed 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 company 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 entity shall determine whether an impairment loss must be recognized in accordance with paragraph 6 of FAS 121. Property occupied by the company shall be evaluated using the asset grouping approach of paragraph 8 of FAS 121. 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 11 of this statement. 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.

10. 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 11 of this statement. Subsequent revisions to the fair value of the asset shall be accounted for in accordance with paragraph 17 of FAS 121.

11. The current fair value of real estate shall be determined on a property by property basis (i.e., increases in the fair value of one property shall not be used to offset declines in fair value of another) and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale (i.e., the buyer and seller acting prudently and knowledgeable with the price not affected by any undue stimulus). If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon an evaluation of all relevant data about the market, considering the following:
   a. A physical inspection of the premises;
   b. The present value of future cash flows generated by the property (Discounted Cash Flows), or capitalization of stabilized net operating income (Direct Capitalization);
   c. Current sales prices of similar properties with adjustments for differences in the properties (Sales Comparison Approach);
   d. Costs to sell the property if the reporting entity does not have the intent or ability to hold the real estate as an investment; and
   e. Replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).

19. 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; and
   c. The caption in the statement of operations in which the impairment loss is aggregated.

50. SSAP No. 24 paragraphs 4, 6 and 7:

4. The determination of whether a gain or loss results from the disposal shall 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 shall also include an
estimate of such amounts. If it is expected that net income will be generated from operations during that period the computation shall 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 SSAP No. 3—Accounting Changes and Corrections of Errors.

6. Additionally, 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 2 above);
   c. The expected manner of disposal;
   d. A description of the remaining assets and liabilities of the segment at the balance sheet date; and
   e. The amounts related to the discontinued operations and the effect on the financial statements, including the balance sheet and income statement line items which have been affected.

7. 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 6 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.

51. SSAP No. 3 paragraphs 3 through 6:

Change in Accounting Principle

3. A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes. A change in the method of applying an accounting principle shall be considered a change in accounting principle.

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

5. The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect 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.

Change in Accounting Estimate

6. 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 changes in loss reserve estimates for property and casualty companies. Accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.
Generally Accepted Accounting Principles

52. FAS 144 provides the following:

Long-Lived Assets to Be Held and Used

Recognition and Measurement of an Impairment Loss

7. For purposes of this Statement, impairment is the condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value. An impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use (paragraph 19) or under development (paragraph 20). An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.

When to Test a Long-Lived Asset for Recoverability

8. A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

a. A significant decrease in the market price of a long-lived asset (asset group)

b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

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 the use of a long-lived asset (asset group)

f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

9. When a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and method as required by APB Opinion No. 20, Accounting Changes, or the amortization period as required by FASB Statement No. 142, Goodwill and Other Intangible Assets. Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability (paragraph 18). However, any change in the accounting method for the asset resulting from that review shall be made only after applying this Statement.

Grouping Long-Lived Assets to Be Held and Used

10. For purposes of recognition and measurement of an impairment loss, a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. However, an impairment loss, if any, that results from applying this Statement shall reduce only the carrying amount of a long-lived asset or assets of the group in accordance with paragraph 14.
11. In limited circumstances, a long-lived asset (for example, a corporate headquarters facility) may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and of other asset groups. In those circumstances, the asset group for that long-lived asset shall include all assets and liabilities of the entity.

12. Goodwill shall be included in an asset group to be tested for impairment under this Statement only if the asset group is or includes a reporting unit. Goodwill shall not be included in a lower-level asset group that includes only part of a reporting unit. Estimates of future cash flows used to test that lower-level asset group for recoverability shall not be adjusted for the effect of excluding goodwill from the group.

13. Other than goodwill, the carrying amounts of any assets (such as accounts receivable and inventory) and liabilities (such as accounts payable, long-term debt, and asset retirement obligations) not covered by this Statement that are included in an asset group shall be adjusted in accordance with other applicable generally accepted accounting principles prior to testing the asset group for recoverability.

14. An impairment loss for an asset group shall reduce only the carrying amounts of a long-lived asset or assets of the group. The loss shall be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort. (Example 1 of Appendix A illustrates the allocation of an impairment loss for an asset group.)

New Cost Basis

15. If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset shall be its new cost basis. For a depreciable long-lived asset, the new cost basis shall be depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.

Estimates of Future Cash Flows Used to Test a Long-Lived Asset for Recoverability

16. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group). Those estimates shall exclude interest charges that will be recognized as an expense when incurred.

17. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity’s own assumptions about its use of the asset (asset group) and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others. However, if alternative courses of action to recover the carrying amount of a long-lived asset (asset group) are under consideration or if a range is estimated for the amount of possible future cash flows associated with the likely course of action, the likelihood of those possible outcomes shall be considered. A probability-weighted approach may be useful in considering the likelihood of those possible outcomes. (Example 2 of Appendix A illustrates the use of that approach when alternative courses of action are under consideration.)

18. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall be made for the remaining useful life of the asset (asset group) to the entity. The remaining useful life of an asset group shall be based on the remaining useful life of the primary asset of the group. For purposes of this Statement, the primary asset is the principal long-lived tangible asset being depreciated or intangible asset being amortized that is the most significant component asset from which the asset group derives its cash-flow-generating capacity. Factors that an entity generally should consider in determining whether a long-lived asset is the primary...
asset of an asset group include the following: (a) whether other assets of the group would have been acquired by the entity without the asset, (b) the level of investment that would be required to replace the asset, and (c) the remaining useful life of the asset relative to other assets of the group. If the primary asset is not the asset of the group with the longest remaining useful life, estimates of future cash flows for the group should assume the sale of the group at the end of the remaining useful life of the primary asset.

19. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) that is in use, including a long-lived asset (asset group) for which development is substantially complete, shall be based on the existing service potential of the asset (asset group) at the date it is tested. The service potential of a long-lived asset (asset group) encompasses its remaining useful life, cash-flow-generating capacity, and for tangible assets, physical output capacity. Those estimates shall include cash flows associated with future expenditures necessary to maintain the existing service potential of a long-lived asset (asset group), including those that replace the service potential of component parts of a long-lived asset (for example, the roof of a building) and component assets other than the primary asset of an asset group. Those estimates shall exclude cash flows associated with future capital expenditures that would increase the service potential of a long-lived asset (asset group).

20. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) that is under development shall be based on the expected service potential of the asset (group) when development is substantially complete. Those estimates shall include cash flows associated with all future expenditures necessary to develop a long-lived asset (asset group), including interest payments that will be capitalized as part of the cost of the asset (asset group).

21. If a long-lived asset that is under development is part of an asset group that is in use, estimates of future cash flows used to test the recoverability of that group shall include the cash flows associated with future expenditures necessary to maintain the existing service potential of the group (paragraph 19) as well as the cash flows associated with all future expenditures necessary to substantially complete the asset that is under development (paragraph 20). (Example 3 of Appendix A illustrates that situation.)

Fair Value

22. The fair value of an asset (liability) is the amount at which that asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, in many instances, quoted market prices in active markets will not be available for the long-lived assets (asset groups) covered by this Statement. In those instances, the estimate of fair value shall be based on the best information available, including prices for similar assets (groups) and the results of using other valuation techniques.

23. A present value technique is often the best available valuation technique with which to estimate the fair value of a long-lived asset (asset group). Paragraphs 39–54 of FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, discuss the use of two present value techniques to measure the fair value of an asset (liability). The first is expected present value, in which multiple cash flow scenarios that reflect the range of possible outcomes and a risk-free rate are used to estimate fair value. The second is traditional present value, in which a single set of estimated cash flows and a single interest rate (a rate commensurate with the risk) are used to estimate fair value. Either present value technique can be used for a fair value measurement. However, for long-lived assets (asset groups) that have uncertainties both in timing and amount, an expected present value technique will often be the appropriate technique. (Example 4 of Appendix A illustrates the use of that technique.)

24. If a present value technique is used, estimates of future cash flows shall be consistent with the objective of measuring fair value. Assumptions that marketplace participants would use in their estimates of fair value shall be incorporated whenever that information is available without undue cost and effort. Otherwise, the entity may use its own assumptions.
Reporting and Disclosure

25. An impairment loss recognized for a long-lived asset (asset group) to be held and used shall be included in income from continuing operations before income taxes in the income statement of a business enterprise and in income from continuing operations in the statement of activities of a not-for-profit organization. If a subtotal such as “income from operations” is presented, it shall include the amount of that loss.

26. The following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment

b. If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement or the statement of activities that includes that loss

c. The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique)

d. If applicable, the segment in which the impaired long-lived asset (asset group) is reported under FASB Statement No. 131, Disclosures about Segments of an Enterprise and Related Information.

Long-Lived Assets to Be Disposed Of Other than by Sale

27. A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange for a similar productive long-lived asset, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until it is disposed of. Paragraphs 7–26 shall apply while the asset is classified as held and used. If a long-lived asset is to be abandoned or distributed to owners in a spinoff together with other assets (and liabilities) as a group and that disposal group is a component of an entity, paragraphs 41–44 shall apply to the disposal group at the date it is disposed of.

Long-Lived Asset to Be Abandoned

28. For purposes of this Statement, a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with Opinion 20 to reflect the use of the asset over its shortened useful life (refer to paragraph 9). A long-lived asset that has been temporarily idled shall not be accounted for as if abandoned.

Long-Lived Asset to Be Exchanged for a Similar Productive Long-Lived Asset or to Be Distributed to Owners in a Spinoff

29. For purposes of this Statement, a long-lived asset to be exchanged for a similar productive long-lived asset or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset (asset group) is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset (disposal group) exceeds its fair value.
Long-Lived Assets to Be Disposed Of by Sale

Recognition

30. A long-lived asset (disposal group) to be sold shall be classified as held for sale in the period in which all of the following criteria are met:

   a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group).

   b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups). (Examples 5–7 of Appendix A illustrate when that criterion would be met.)

   c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.

   d. The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 31. (Example 8 of Appendix A illustrates when that criterion would be met.)

   e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.

   f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If at any time the criteria in this paragraph are no longer met (except as permitted by paragraph 31), a long-lived asset (disposal group) classified as held for sale shall be reclassified as held and used in accordance with paragraph 38.

31. Events or circumstances beyond an entity’s control may extend the period required to complete the sale of a long-lived asset (disposal group) beyond one year. An exception to the one-year requirement in paragraph 30(d) shall apply in the following situations in which such events or circumstances arise:

   a. If at the date an entity commits to a plan to sell a long-lived asset (disposal group) the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (group) that will extend the period required to complete the sale and (1) actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained and (2) a firm purchase commitment is probable within one year. (Example 9 of Appendix A illustrates that situation.)

   b. If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a long-lived asset (disposal group) previously classified as held for sale that will extend the period required to complete the sale and (1) actions necessary to respond to the conditions have been or will be timely initiated and (2) a favorable resolution of the delaying factors is expected. (Example 10 of Appendix A illustrates that situation.)

   c. If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset (disposal group) previously classified as held for sale is not sold by the end of that period and (1) during the initial one-year period the entity initiated actions necessary to respond to the change in circumstances, (2) the asset (group) is being actively marketed at a price that is reasonable given the change in circumstances, and (3) the criteria in paragraph 30 are met. (Example 11 of Appendix A illustrates that situation.)
32. A long-lived asset (disposal group) that is newly acquired and that will be sold rather than held and used shall be classified as held for sale at the acquisition date only if the one-year requirement in paragraph 30(d) is met (except as permitted by paragraph 31) and any other criteria in paragraph 30 that are not met at that date are probable of being met within a short period following the acquisition (usually within three months).

33. If the criteria in paragraph 30 are met after the balance sheet date but before issuance of the financial statements, a long-lived asset shall continue to be classified as held and used in those financial statements when issued. The information required by paragraph 47(a) shall be disclosed in the notes to the financial statements. If the asset (asset group) is tested for recoverability (on a held-and-used basis) as of the balance sheet date, the estimates of future cash flows used in that test shall consider the likelihood of possible outcomes that existed at the balance sheet date, including the assessment of the likelihood of the future sale of the asset. That assessment made as of the balance sheet date shall not be revised for a decision to sell the asset after the balance sheet date. An impairment loss, if any, to be recognized shall be measured as the amount by which the carrying amount of the asset (asset group) exceeds its fair value at the balance sheet date.

Measurement

34. A long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell. If the asset (disposal group) is newly acquired, the carrying amount of the asset (disposal group) shall be established based on its fair value less cost to sell at the acquisition date. A long-lived asset shall not be depreciated (amortized) while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be accrued.

35. Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made. Those costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Those costs exclude expected future losses associated with the operations of a long-lived asset (disposal group) while it is classified as held for sale. If the sale is expected to occur beyond one year as permitted in limited situations by paragraph 31, the cost to sell shall be discounted.

36. The carrying amounts of any assets that are not covered by this Statement, including goodwill, that are included in a disposal group classified as held for sale shall be adjusted in accordance with other applicable generally accepted accounting principles prior to measuring the fair value less cost to sell of the disposal group.

37. A loss shall be recognized for any initial or subsequent write-down to fair value less cost to sell. A gain shall be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized (for a write-down to fair value less cost to sell). The loss or gain shall adjust only the carrying amount of a long-lived asset, whether classified as held for sale individually or as part of a disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset (disposal group) shall be recognized at the date of sale.

Changes to a Plan of Sale

38. If circumstances arise that previously were considered unlikely and, as a result, an entity decides not to sell a long-lived asset (disposal group) previously classified as held for sale, the asset (disposal group) shall be reclassified as held and used. A long-lived asset that is reclassified shall be measured individually at the lower of its (a) carrying amount before the asset (disposal group) was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset (disposal group) been continuously classified as held and used, or (b) fair value at the date of the subsequent decision not to sell.
39. Any required adjustment to the carrying amount of a long-lived asset that is reclassified as held and used shall be included in income from continuing operations in the period of the subsequent decision not to sell. That adjustment shall be reported in the same income statement caption used to report a loss, if any, recognized in accordance with paragraph 45. If a component of an entity is reclassified as held and used, the results of operations of the component previously reported in discontinued operations in accordance with paragraph 43 shall be reclassified and included in income from continuing operations for all periods presented.

40. If an entity removes an individual asset or liability from a disposal group previously classified as held for sale, the remaining assets and liabilities of the disposal group to be sold shall continue to be measured as a group only if the criteria in paragraph 35 are met. Otherwise, the remaining long-lived assets of the group shall be measured individually at the lower of their carrying amounts or fair values less cost to sell at that date. Any long-lived assets that will not be sold shall be reclassified as held and used in accordance with paragraph 36.

Reporting Long-Lived Assets and Disposal Groups to Be Disposed Of

Reporting Discontinued Operations

41. For purposes of this Statement, a component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment (as those terms are defined in paragraph 10 of Statement 131), a reporting unit (as that term is defined in Statement 142), a subsidiary, or an asset group (as that term is defined in paragraph 4).

42. The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations in accordance with paragraph 43 if both of the following conditions are met: (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction. (Examples 12-15 of Appendix A illustrate disposal activities that do or do not qualify for reporting as discontinued operations.)

43. In a period in which a component of an entity either has been disposed of or is classified as held for sale, the income statement of a business enterprise (or statement of activities of a not-for-profit organization) for current and prior periods shall report the results of operations of the component, including any gain or loss recognized in accordance with paragraph 37, in discontinued operations. The results of operations of a component classified as held for sale shall be reported in discontinued operations in the period(s) in which they occur. The results of discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income before extraordinary items and the cumulative effect of accounting changes (if applicable). For example, the results of discontinued operations may be reported in the income statement of a business enterprise as follows:

Income from continuing operations before income taxes $XXXX
Income taxes XXX
Income from continuing operations 24 $XXXX
Discontinued operations (Note X)
Loss from operations of discontinued Component X XXX
(including loss on disposal of $XXX)
Income tax benefit XXX
Loss on discontinued operations XXX
Net income $XXXX

A gain or loss recognized on the disposal shall be disclosed either on the face of the income statement or in the notes to the financial statements (paragraph 47(b)).
44. Adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be classified separately in the current period in discontinued operations. The nature and amount of such adjustments shall be disclosed. Examples of circumstances in which those types of adjustments may arise include the following:

   a. The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser

   b. The resolution of contingencies that arise from and that are directly related to the operations of the component prior to its disposal, such as environmental and product warranty obligations retained by the seller

   c. The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction.

Reporting Disposal Gains or Losses in Continuing Operations

45. A gain or loss recognized for a long-lived asset (disposal group) classified as held for sale that is not a component of an entity shall be included in income from continuing operations before income taxes in the income statement of a business enterprise and in income from continuing operations in the statement of activities of a not-for-profit organization. If a subtotal such as “income from operations” is presented, it shall include the amounts of those gains or losses.

Reporting a Long-Lived Asset or Disposal Group Classified as Held for Sale

46. A long-lived asset classified as held for sale shall be presented separately in the statement of financial position. The assets and liabilities of a disposal group classified as held for sale shall be presented separately in the asset and liability sections, respectively, of the statement of financial position. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the statement of financial position or in the notes to financial statements (paragraph 47(a)).

Disclosure

47. The following information shall be disclosed in the notes to the financial statements that cover the period in which a long-lived asset (disposal group) either has been sold or is classified as held for sale:

   a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group

   b. The gain or loss recognized in accordance with paragraph 37 and if not separately presented on the face of the income statement, the caption in the income statement or the statement of activities that includes that gain or loss

   c. If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations

   d. If applicable, the segment in which the long-lived asset (disposal group) is reported under Statement 131.
48. If either paragraph 38 or paragraph 40 applies, a description of the facts and circumstances leading to the decision to change the plan to sell the long-lived asset (disposal group) and its effect on the results of operations for the period and any prior periods presented shall be disclosed in the notes to financial statements that include the period of that decision.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Statement of Statutory Accounting Principles No. 3—Accounting Changes and Corrections of Errors
- Statement of Statutory Accounting Principles No. 24—Discontinued Operations and Extraordinary Items
- Statement of Statutory Accounting Principles No. 40—Real Estate Investments

Generally Accepted Accounting Principles

- FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of
- FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets
EXHIBIT A: Illustration of Marked Changes to Amended SSAPs

The following depicts the amendments made by this issue paper as “marked changes” (new text underlined and deleted text struck-through). These amendments may ultimately be revised in the final statement of statutory accounting principle.

SSAP No. 40 paragraph 9:

Properties occupied by the company 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 8§ of *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144) provides examples of events or changes in circumstances which indicate that the recoverability of the carrying amount of properties occupied by the company or properties held for the production of income should be assessed. If the events or changes in circumstances set forth in paragraph 8§ of FAS 144 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 entity shall determine whether an impairment loss must be recognized in accordance with paragraph 76 of FAS 144. In evaluating the recoverability of properties occupied by the company or properties held for the production of income, the reporting entity should utilize the methods of estimating future cash flows in accordance with paragraphs 16 through 21 of FAS 144. Property occupied by the company shall be evaluated using the asset grouping approach of paragraph 8 of FAS 121. Paragraphs 10 and 11 of FAS 144. 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 11 of SSAP No. 40, as modified by 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.

SSAP No. 40 paragraph 10:

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 34 of FAS 144. The intent to sell a property exists when the criteria set forth in paragraph 30 of FAS 144 are met: 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 11 of SSAP No. 40, as modified by this issue paper. Subsequent revisions to the fair value of the asset shall be accounted for in accordance with paragraph 37 of FAS 144, as modified by this issue paper 01.

SSAP No. 40 paragraph 19:

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; and
c. The caption in the statement of operations in which the impairment loss is aggregated.

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; and

c. The caption in the statement of operations in which the impairment loss is aggregated.

In the period in which a property classified as held for sale has either been sold or is classified as held for sale, the reporting entity shall disclose the following:

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal; and

b. If applicable, the gain or loss recognized and if not separately presented on the face of the statement of operations, the caption in the statement of operations that includes that gain or loss.

If the reporting entity makes changes to a plan of sale in accordance with paragraphs 38 and 40 of FAS 144, in the period of that decision the reporting entity shall disclose a description of the facts and circumstances leading to the decision to change the plan to sell the asset and its effect on the results of operations for the period and any prior periods presented.
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Statutory Issue Paper No. 122

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

STATUS
Adopted December 8, 2003

Type of Issue:
Common

SUMMARY OF ISSUE

1. Current statutory accounting guidance for transfers and servicing of financial assets and extinguishments of liabilities is provided in SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18). Current statutory accounting guidance for asset securitizations and securitizations of policy acquisition costs is provided in SSAP No. 33—Securitization (SSAP No. 33). Current statutory accounting guidance for repurchase agreements, reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements is provided in SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (SSAP No. 45). SSAP No. 18, SSAP No. 33 and SSAP No. 45 adopted FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125) with modification for statutory accounting purposes. The modifications to FAS 125 primarily relate to:

   a. The nonadmission of servicing rights assets;

   b. The accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements;

   c. The accounting for realized gains and losses for reporting entities required to maintain an IMR;

   d. The accounting for financial assets subject to prepayment;

   e. The accounting for assets pledged as collateral;

   f. The accounting for leases in accordance with SSAP No. 22—Leases (SSAP No. 22);

   g. The accounting for sales of receivables with recourse; and

   h. Paragraph 14 of FAS 125 is rejected as it relates to classifications of securities under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115). FAS 115 is rejected in SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities (SSAP No. 26).

2. In September 2000, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140). FAS 140 replaces FAS 125. FAS 140 reconsiders or clarifies the guidance in FAS 125 concerning the following:

   a. Circumstances in which a special-purpose entity (SPE) can be considered qualifying;

   b. Circumstances in which the assets held by a qualifying SPE should appear in the consolidated financial statements of the transferor;
c. Whether sale accounting is precluded if the transferor holds a right to repurchase transferred assets that is attached to, is embedded in, or is otherwise transferable with the financial assets;

d. Circumstances in which sale accounting is precluded if transferred financial assets can be removed from a SPE by the transferor (for example under a removal-of-accounts provision (ROAP));

e. Whether arrangements that obligate, but do not entitle, a transferor to repurchase or redeem transferred financial assets should affect the accounting for those transfers;

f. The impact of the powers of the Federal Deposit Insurance Corporation (FDIC) on isolation of assets transferred by financial institutions;

g. Whether transfers of financial assets measured using the equity method of accounting should continue to be included in the scope of FAS 125;

h. Whether disclosures should be enhanced to provide more information about assumptions used to determine the fair value of retained interests and the gain or loss on financial assets sold in securitizations; and

i. The accounting for and disclosure about collateral that can be sold or repledged.

3. The purpose of this issue paper is to establish statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this issue paper. Securitizations of nonfinancial assets are outside the scope of this issue paper.

RECOMMENDED CONCLUSION

4. See SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25) for additional accounting and disclosure guidance concerning related party transactions. In addition the guidance for the following topics have been addressed in Interpretations of the Emerging Accounting Issues Working Group:

a. INT 99-22: EITF 98-8 Accounting for Transfers of Investments That Are in Substance Real Estate resolved this conflict between application of SSAP No. 40—Real Estate Investments and SSAP No. 18.

b. INT 99-21: EITF 98-7 Accounting for Exchanges of Similar Equity Method Investments resolved this conflict between application of SSAP No. 28—Nonmonetary Transactions and SSAP No. 18.

5. SSAP No. 18, SSAP No. 33 and SSAP No. 45 are superseded by the conclusions outlined in this issue paper.

6. This issue paper does not address the securitization of mortality or morbidity risk. The NAIC’s Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the development of model laws, model regulations and proposed accounting guidance for the securitization of mortality and morbidity risk. When such proposed accounting guidance is finalized the development of an issue paper will be considered.
7. Except as discussed in paragraphs 57 and 89, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 18 and 19);

b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraphs 20-24), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 26 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 25), to pledge or exchange those interests and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provide more than a trivial benefit to the transferor; and

c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 39-41) or (ii) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 23-24 and 42-46).

8. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its balance sheet any retained interest in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and retained undivided interests (see paragraphs 9 c., 49 and 50); and

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (see paragraphs 49 and 50).

9. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 7), the transferor (seller) shall:

a. Eliminate the transferred assets from the balance sheet;

b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;

c. Record in its balance sheet, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities). Subsequent to the transfer of assets:

i. Retained residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;
ii. Retained beneficial interests shall be accounted for in accordance with the statutory accounting principles for the specific asset type (e.g., bonds shall be accounted for in accordance with SSAP No. 26, loan-backed securities shall be accounted for in accordance with SSAP No. 43—Loan-backed and Structured Securities, preferred stock in accordance with SSAP No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities).

d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 9 c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see Glossary), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 51); and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

10. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).

11. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements are described in paragraphs 68 - 78. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 92. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 7, or (b) is a sale of receivables with recourse (see paragraph 89); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 14).

Recognition and Measurement of Servicing Assets and Liabilities

13. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.
Secured Borrowings and Collateral

14. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:

   a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:

      The debtor shall reclassify that asset and report that asset in its balance sheet separately (for example, as security pledged to creditors) from other assets not so encumbered;

      The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

   b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;

   c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;

   d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.

15. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. If the assets pledged are recorded as admitted assets under SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) and are not impaired under the provisions of SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5), the pledging insurer records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 14 above shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party’s utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an admitted asset for the amount of collateral that it can redeem.
Extinguishments of Liabilities

16. A debtor shall derecognize a liability if, and only if, it has been extinguished (see SSAP No. 15—Debt and Holding Company Obligations). A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds; or

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

17. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

Isolation Beyond the Reach of the Transferor and Its Creditors

18. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor. Transactions between related parties or affiliates are accounted for in accordance with SSAP No. 25.

19. Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

20. Sale accounting is allowed under paragraph 7 only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer’s business or someone that the loan customer might
consider an undesirable creditor. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

21. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

22. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor’s Rights or Obligations to Reacquire Transferred Assets

23. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 7. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 7.

24. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets, as discussed in paragraphs 42–46, thus precluding sale accounting under paragraph 7.
Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

25. The considerations in paragraphs 20-23, about conditions that may or may not constrain a transferee that is not a qualifying special-purpose entity (SPE) from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a beneficial interest holder (BIH) from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

26. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:
   a. It is demonstrably distinct from the transferor (paragraphs 27 and 28);
   b. Its permitted activities:
      i. Are significantly limited;
      ii. Were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; and
      iii. May be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 29 and 30).
   c. It shall hold only:
      i. Financial assets transferred to it that are passive in nature (paragraph 31);
      ii. Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 31 and 32);
      iii. Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE;
      iv. Servicing rights related to financial assets that it holds;
      v. Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 33);
      vi. Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).
   d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
i. Occurrence of an event or circumstance that:
   
   (a) Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;
   
   (b) Is outside the control of the transferor, its affiliates, or its agents; and
   
   (c) Causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 34 and 35.)

ii. Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder’s beneficial interest back to the SPE (paragraph 36);

iii. Exercise by the transferor of a call specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 42-46);

iv. Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 37).

Need to Be Demonstrably Distinct from the Transferor

27. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either:

   a. At least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents; or

   b. The transfer is a guaranteed mortgage securitization.

28. An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

29. The powers of the SPE must be limited to those activities allowed by paragraph 26 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

30. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 7 b. are then met by the SPE itself and the conditions in paragraphs 7 a. and 7 c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 47).
Limits on What a Qualifying SPE May Hold

31. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing. An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control, as defined in SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46), over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments that would allow it and its related entities to control 10% of more of the financial instruments issuer; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE’s assets.

32. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

   a. Is entered into:
      
      i. When the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents; or
      
      ii. When a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold.

   b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently;

   c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

33. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets.

Limits on Sales or Other Dispositions of Assets

34. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that:

   a. Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

   b. Is outside the control of the transferor, its affiliates, or its agents; and
c. Causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them—include requirements to dispose of transferred assets in response to:

i. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee;

ii. A default by the obligor;

iii. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating;

iv. The involuntary insolvency of the transferor; or

v. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

35. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure;

b. A requirement to dispose of marketable equity securities upon a specified decline from their “highest fair value” if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE;

c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

36. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets;

b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put);

c. New beneficial interests in those assets.

37. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two
specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

**Investments in Special-Purpose Entities**

38. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 46. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25.

**Agreements That Maintain Effective Control Over Transferred Assets**

39. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

- **a.** The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 40);
- **b.** The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 41);
- **c.** The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and
- **d.** The agreement is entered into concurrently with the transfer.

40. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

- **a.** The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);
- **b.** Identical form and type so as to provide the same risks and rights;
- **c.** The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);
- **d.** Identical contractual interest rates;
- **e.** Similar assets as collateral; and
- **f.** The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

41. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.
Ability to Unilaterally Cause the Return of Specific Transferred Assets

42. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 7. For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor’s maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor’s maintaining effective control, because it is the issuer rather than the transferor who holds the call.

43. If the transferee is a qualifying SPE, it has met the conditions in paragraph 26 and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor’s effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor's unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

44. A call that is attached to transferred assets maintains the transferor’s effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor’s effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor’s effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

45. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

46. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service
the transferred assets that could result in the loss of a third-party guarantee (paragraph 34 c. i.) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase that beneficial interest (paragraph 36 b.), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor’s Regaining Control of Assets Sold

47. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor’s regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 7 are no longer met. Such a change, unless it arises solely from either the initial application of this issue paper or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 9). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 30). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor. Subsequent to that date, the reporting entity shall follow statutory accounting for the assets and liabilities in accordance with the guidance in the SSAPs.

Assets Obtained and Liabilities Incurred as Proceeds

48. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Retained Interests

49. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 48.

50. If the retained interests are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.
If It Is Not Practicable to Estimate Fair Values

51. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

b. The amount that would be recognized in accordance with SSAP No. 5.

Securitizations

52. Financial assets such as mortgage loans are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties also have been securitized. Securitizations of nonfinancial assets are outside the scope of this issue paper.

53. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

54. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

55. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 7 qualify for sale accounting under this issue paper. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 9; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Sales of Future Revenues

56. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

57. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). If there is a ROAP, the transfer of assets shall not be accounted for as a sale.

Securities Lending Transactions

58. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor’s balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor’s balance sheet and a separate liability shall be established on the transferor’s balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nondiscovery of the undercollateralized portion. The specific collateral requirements are as follows:

a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities;

b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.

59. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer’s failure to deliver securities sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

60. Many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 39-41). Those transactions shall be
accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 14 and 58.

61. In some transactions, characterized as securities lending, all of the criteria in paragraph 7 are met, including the effective control criterion in paragraph 7 c., and consideration other than beneficial interests in the transferred assets is received. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:

   a. By the transferor as a sale of the loaned securities, for proceeds consisting of the collateral and a forward repurchase commitment. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and

   b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.

Repurchase Agreements and "Wash Sales"

62. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.

63. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

64. If the criteria in paragraph 7 are met, including the criterion in paragraph 7 c. i., the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at
maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

65. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales under this issue paper. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

66. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 7 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 40) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

67. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

**Repurchase Agreements**

68. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 40 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

69. For repurchase agreements that are accounted for as collateralized lendings in accordance with paragraph 66 of this statement, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

70. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

**Reverse Repurchase Agreements**

71. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 40 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

72. For reverse repurchase agreements that are accounted for as collateralized borrowings in accordance with paragraph 66 of this statement, the underlying securities shall continue to be accounted
for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded
as a liability, and the difference between the proceeds and the amount at which the securities will be
subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the
scientific interest (constant yield) method, over the term of the agreement.

**Collateral Requirements**

73. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

   Repurchase Transaction

   a. The reporting entity shall receive as collateral transferred securities having a fair value at
   least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at
   anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the
   reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value
   of which, together with fair value of all collateral then held in connection with the transaction, at
   least equals 102 percent of the purchase price.

   Reverse Repurchase Transaction

   b. The reporting entity shall receive collateral having a fair value as of the transaction date
   at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in
   the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent
   of the fair value of the securities so transferred, the counterparty shall be obligated to deliver
   additional collateral, the fair value of which, together with the fair value of all collateral then held
   in connection with the transaction, at least equals 95 percent of the fair value of the transferred
   securities.

**Dollar Repurchase Agreements**

74. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse
repurchase agreements involving debt instruments that are pay-through securities collateralized with
Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation
(FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates
sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities
issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll
transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the
securities underlying the agreements must meet the criteria defined in paragraph 40, and for mortgage-
backed securities excluding mortgage pass-through securities, the projected cash flows of the securities
must be substantially the same under multiple scenario prepayment assumptions.

75. For the seller in a dollar reverse repurchase agreement accounted for as collateralized borrowing
in accordance with paragraph 66 of this statement, a liability is recorded for the amount of proceeds of the
sale and the sold mortgage-backed securities are not removed from the accounting records. During the
period of the agreement, interest income is recorded as if the mortgage-backed security had been held
during the term of the agreement. This is offset by an equal amount of interest expense related to the
proceeds received from the sale. Additional interest expense is recorded representing the difference
between the sales price and the repurchase price of the mortgage-backed securities sold.

76. When the mortgage-backed securities are repurchased under the agreement, the original
mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-
backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must
be in good delivery form consistent with paragraph 40.
77. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

78. For the purchaser in a dollar repurchase agreement accounted for as collateralized lending in accordance with paragraph 67 of this statement, an asset is recorded for the amount of the purchase. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

79. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 60 and 66 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

80. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

81. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

   a. A legal right of offset exists as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64); or
   
   b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

82. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications

83. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

84. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

85. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.
86. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

87. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 7 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor’s right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor’s permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor’s competitor is a limitation on the transferee’s rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

88. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 7 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

89. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42—Sale of Premium Receivables.

Disclosures

90. A reporting entity shall disclose the following:

a. For collateral:

   i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security;

   ii. If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 14 a., the carrying amount and classification of those assets as of the date of the latest statement of financial position presented;

   iii. If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral; and
iv. For securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date.

b. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding;

c. If assets are set aside solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets;

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;

e. For all servicing assets and servicing liabilities:

i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and

ii. The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary); and

ii. The characteristics of securitizations (a description of the transferor’s continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations;

iii. The key assumptions used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and

iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained.)

g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary);
ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);

iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii. above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and

iv. For the securitized assets and any other financial assets that the entity manages together with the retained interests:

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;

(b) Delinquencies at the end of the period; and

(c) Credit losses, net of recoveries, during the period.

v. Disclosure of average balances during the period is encouraged, but not required.

h. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;

i. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

j. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

91. Disclose any transfers of receivables with recourse.

92. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 11, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

a. A description of the reporting entity’s objectives regarding these transactions;

b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;

c. The number of transactions involved during the reporting period;

d. The book value of securities sold;

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1 Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.
c. The cost of securities repurchased; and

f. The realized gains/losses associated with the securities involved.

93. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 92 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

**Effective Date and Transition**

94. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2005, and shall be applied prospectively.

95. For each servicing contract in existence before January 1, 2005, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

**DISCUSSION**

96. The accounting guidance in this issue paper is consistent with the guidance included in SSAP No. 18, SSAP No. 33 and SSAP No. 45, and is expanded to include issues addressed in FAS 140.

97. This statement adopts FAS 140 with the following modifications:

a. Servicing rights assets are nonadmitted;

b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. As statutory financial statements are prepared on a legal entity basis, special purpose entities shall not be consolidated in a reporting entity’s statutory financial statements;

d. Leases shall be accounted for in accordance with SSAP No. 22;

e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and

f. The concepts of revolving-period securitizations, banker’s acceptances and risk participations in banker’s acceptances are not applicable for statutory accounting purposes.

98. This issue paper adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB Emerging Issues Task Force No. 88-18, Sales of
ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES

IP No. 122


99. This issue paper rejects FASB Emerging Issues Task Force No. 84-5, Sale of Marketable Securities with a Put Option, and FASB Emerging Issues Task Force No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse.

RELEVANT STATUTORY AND GAAP GUIDANCE:

Statutory Accounting

100. SSAP No. 18 provides the following guidance:

SUMMARY CONCLUSION

3. Except as discussed in paragraph 35, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 12 and 13);

b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraph 14), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 9 of SSAP No. 33 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 14), to pledge or exchange those interests; and

c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 15-17) or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (see paragraph 18).

4. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its balance sheet any retained interest in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (see SSAP No. 33), and retained undivided interests (see paragraph 20); and

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (see paragraphs 19 and 20).

5. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 3), the transferor (seller) shall:
a. Eliminate the transferred assets from the balance sheet;
b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;
c. Record in its balance sheet, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);
d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 5 c.) and liabilities incurred in consideration as proceeds of the sale;
e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and
f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses in the statement of income.

6. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).

7. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements shall meet the definition of SSAP No. 45. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 37. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

8. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 3, or (b) is a sale of receivables with recourse (see paragraph 35); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 10).

Recognition and Measurement of Servicing Assets and Liabilities

9. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.
Secured Borrowings and Collateral

10. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 8). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:

a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:
   i. The debtor shall disclose the amount of such assets and the secured party’s right to sell or repledge such collateral;
   ii. The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;

d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

11. A debtor shall derecognize a liability if, and only if, it has been extinguished (see SSAP No. 15). A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities; or

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Isolation Beyond the Reach of the Transferor and Its Creditors

12. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All
available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (see SSAP No. 33).

13. Many common financial transactions, for example, typical repurchase agreements (see SSAP No. 45) and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

14. Many transferor-imposed or other conditions on a transferee’s contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor’s right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor’s permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor’s competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor’s competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Agreements That Maintain Effective Control Over Transferred Assets

15. An agreement that both entities and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (see paragraph 16);

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (see paragraph 17);

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and

d. The agreement is entered into concurrently with the transfer.

16. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

b. Identical form and type so as to provide the same risks and rights;
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);

d. Identical contractual interest rates;

e. Similar assets as collateral; and

f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

17. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

18. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor’s effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Assets Obtained and Liabilities Incurred as Proceeds

19. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds of the transfer. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Retained Interests

20. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 19.

Fair Value

21. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

22. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the
circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm’s-length transaction.

23. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Values

24. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

   a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

   b. The amount that would be recognized in accordance with SSAP No. 5—Liabilities, Contingencies and Impairments of Assets.

Securities Lending Transactions

25. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities should be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor’s balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor’s balance sheet and a separate liability shall be established on the transferor’s balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:

   a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities.
b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.

26. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer’s failure to deliver securities sold. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

27. Securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (see paragraphs 15-18). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 10 and 25.

28. In some transactions, characterized as securities lending, all of the criteria in paragraph 3 are met. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:

a. By the transferor as a sale of the loaned securities, for proceeds consisting of the collateral and a forward repurchase commitment. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and

b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.
Loan Syndications

29. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

30. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

31. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

32. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

33. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 3 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor’s right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor’s permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor’s competitor is a limitation on the transferee’s rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

34. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 3 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

35. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42.
Disclosures

36. A reporting entity shall disclose the following:
   a. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;
   b. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted; and
   c. For all servicing assets and servicing liabilities:
      i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and
      ii. The fair value of servicing liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

37. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 7, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
   a. A description of the reporting entity’s objectives regarding these transactions;
   b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
   c. The number of transactions involved during the reporting period;
   d. The book value of securities sold;
   e. The cost of securities repurchased; and
   f. The realized gains/losses associated with the securities involved.

38. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 37 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Relevant Literature

39. This statement adopts FAS 125 with modification to paragraphs 9, 10 a., 11 d., 13, 15—17, 35—41, and 68. Additionally, paragraphs 14, 59—60, 77—81, and 83 are rejected. The modifications to FAS 125 primarily relate to (a) the nonadmission of servicing rights assets, (b) the accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements, (c) the accounting for realized gains and losses for reporting entities required to maintain an IMR, (d) the accounting for financial assets subject to prepayment, (e) the accounting for assets pledged as collateral, (f) the accounting for leases in accordance with SSAP No. 22—Leases, and (g) the accounting for sales of receivables with recourse. Paragraphs 77-81 are rejected because they are not applicable to the insurance industry.

40. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force


Effective Date and Transition

42. This statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2001, and shall be applied prospectively.

43. For each servicing contract in existence before January 1, 2001, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

101. SSAP No. 33 provides the following guidance:

Accounting for Securitizations of Financial Assets

3. A financial asset shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both

   a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with the second entity; and

   b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.

4. A securitization in which the transferor surrenders control over the financial asset transferred shall be accounted for as a sale, with recognition of proceeds and measurement of a gain or loss only to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The portion of the securitization for which beneficial interests in the transferred assets are received shall not be accounted for as a sale, but shall be treated as an exchange of assets with no measurement of a gain or loss. All other securitizations shall be accounted for as secured borrowings in accordance with paragraph 11.

5. The transferor has surrendered control if, and only if, all of the following conditions are met:
a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;

b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests; and

c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that entitles and obligates the transferor to repurchase or redeem them before their maturity, or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

6. A beneficial interest shall be defined as the right to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest or principal inflows to be “passed through” or “paid through,” premiums due guarantors, and residual interests. Residual interests are interests in the cash flows of the trust or other entity, after the cash flows of structured securities issued by the trust are met.

7. Upon completion of the securitization of financial assets meeting the criteria for sales treatment required by paragraph 5, the transferor shall:

a. Eliminate the transferred assets from the statement of financial position;

b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;

c. Record in its statement of financial position, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);

d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 7 c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses line in the Investment Income section of the Underwriting and Investment Exhibit.

8. The successor (transferee) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.

9. A qualifying special-purpose entity (including a CMO special-purpose entity) as used in this statement must meet all of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
i. Holding title to transferred financial assets;

ii. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.);

iii. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held; and

iv. Distributing proceeds to the holders of its beneficial interests.

b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

Investments in Special-Purpose Entities

10. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.

Secured Obligations and Collateral

11. Securitizations of financial assets that do not meet the criteria for sale treatment set forth in paragraph 5 shall be presumed to be secured borrowings and shall be recorded as follows. Financial assets shall remain on the reporting entity’s books and a liability shall be recorded to reflect the proceeds from the issuance of any type of certificate. Non-cash proceeds shall be recorded as a contra liability and netted against the liability. The liability shall be reduced as the obligation to holders of beneficial interests is repaid. Financial assets pledged as collateral shall not be offset against the liability reflecting the proceeds of the transaction.

Recognition of Servicing Rights

12. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). The servicing asset or liability shall be measured in a manner consistent with paragraphs 13 and 35 through 38 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125).
Sales of Future Revenues

13. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Relevant Literature

14. This statement adopts portions of FAS 125, with the following modifications (FAS 125 is addressed in its entirety in SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities):

a. This statement requires servicing rights assets to be nonadmitted;

b. This statement does not permit sales treatment for transactions where recourse provisions exist or where “call” or “put” options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. This statement requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FAS 125 requires the encumbered assets to be reported separately from unencumbered assets;

d. This statement does not address transfers of financial assets accomplished in a manner other than through securitizations whereas FAS 125 does address such transfers; and

e. Paragraph 14 is rejected as it is not applicable.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

102. SSAP No. 45 provides the following guidance:

2. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Repurchase Agreements

3. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date within 12 months of the purchase. For securities to be substantially the same, the criteria defined in paragraph 14 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

4. Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting
entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

5. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

6. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria defined in paragraph 13 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

7. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement. Although recording these transactions gross tends to inflate assets and liabilities, it more closely reflects the financing nature of the transactions and their associated leverage impact to the financial statements.

Collateral Requirements

8. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Reverse Repurchase Transaction

b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.
Dollar Repurchase Agreements

9. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 13, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

10. For the seller in a dollar reverse repurchase agreement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

11. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 13.

12. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

13. For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of the purchase. Since the term of the agreement is limited to twelve months, it is accounted for as a short-term investment. Upon completion of the reverse repurchase agreement, cash is received in exchange for a "substantially the same" security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Criteria to Meet Substantially the Same

14. For debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same;

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder;

c. The debt instruments must bear the identical contractual interest rate;
d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield;

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages; and

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.

Separate Transactions

15. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 3, 6, or 8 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

16. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

17. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64), or

b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

Otherwise, separate assets and liabilities shall be recognized.

Disclosures

18. The following disclosures shall be made in the financial statements:

a. If the reporting entity has entered into repurchase agreements, its policy for requiring collateral or other security;

b. A description of the securities underlying the agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

c. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.
19. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

20. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used In Certain Audit Guides and a Statement of Position.

21. This statement adopts paragraphs 9 through 13, 15 through 17, 23 through 25, 27 through 30 and 66 through 71 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125), as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements.

22. This statement adopts FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls. This statement is consistent with FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105 (FIN 39) (as it relates to reverse repurchase and repurchase agreements) and FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39 (FIN 41). FIN 39 and FIN 41 are adopted in SSAP No. 64.

23. This statement rejects paragraph 14 of FAS 125 as it relates to the classifications of securities under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115). FAS 115 is rejected in SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities.

Effective Date and Transition

24. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

INT 01-31: Assets Pledged as Collateral (INT 01-31) provides the following guidance:

INT 01-31 Issue

1. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. The arrangement is commonly referred to as a pledge, typically accomplished by delivery of assets to the secured party or to an independent custodian. In these transactions, the pledging insurer typically (1) continues to receive the income on the pledged collateral and (2) can remove and substitute other securities with little or no advance notice to the secured party as long as they comply with related investment quality and market value agreement provisions. Examples include collateral pledged under investment, derivative, debt obligations and policyholder transactions.

2. Specific examples of collateral pledged for derivative and investment transactions include but are not limited to: (1) securities posted with a broker as margin for futures and options transactions, (2) securities pledged to secure credit exposure with swap counterparties, (3) securities pledged under reverse repurchase agreements or securitizations that are accounted for as secured borrowing transactions and (4) securities pledged under securities lending transactions.

3. Specific examples of collateral pledged for debt obligations and policyholder transactions include but are not limited to assets pledged to secure (1) debt borrowings from or insurance
contracts issued to banking entities and (2) insurance contracts issued to governmental entities such as municipalities.

4. Under these transactions, the fair value of the securities pledged as collateral may exceed the contract balance (swap fair value, advance balance, policyholder account balance, etc). For this interpretation, this excess carrying value of securities pledged over the corresponding asset or contract balance is called the “overcollateralization” amount.

5. The accounting issue is whether the assets pledged as collateral under the various transactions mentioned above should be considered admitted assets.

INT 01-31 Discussion

6. The working group reached a consensus that if the collateral had not been pledged in the examples described above, it is assumed the underlying asset would be recorded as an admitted asset under SSAP No. 4 (e.g. they are readily marketable assets available to meet both current and future policyholder obligations). In addition, it is assumed that the asset would not be considered impaired under SSAP No. 5 due to a default, market value decline, or other loss contingency.

7. Therefore, for the examples described above, the pledging insurer would record the collateral (including the overcollateralization amount) as an admitted asset until they have committed a contract default that has not been cured in accordance with the contract provisions. This accounting is in accordance with the provisions of SSAP Nos. 18, 33 and 45. This consensus of reporting collateral as an admitted asset is further supported by SSAP Nos. 4 and 5 since generally, the insurer can readily substitute pledged assets. Additionally, an insurer may typically unwind the transaction allowing the assets to be available to the pledging insurer to meet policyholder obligations. Furthermore, no event has occurred to indicate an impairment or potential loss contingency with respect to such pledged assets. The fact that some pledged assets may constitute an overcollateralization amount does not change this analysis. Accordingly, all assets pledged in support of these type transactions should also be admitted.

8. At the time of an uncured default, the provisions of paragraph 10 of SSAP No. 18 shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset should be removed from the balance sheet since that obligation has been satisfied through the secured party’s utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer should only record an admitted asset for the amount of collateral that it can redeem.

INT 01-31 Status

9. The consensus position of this interpretation is consistent with the position of the NAIC Invested Asset (E) Working Group. This interpretation will be reviewed by the FAS 140 Subgroup of the NAIC Statutory Accounting Principles (E) Working Group in conjunction of its consideration of incorporating GAAP pronouncement FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125 into the statutory accounting model. As such, this interpretation is subject to amendment pending disposition of the FAS 140 Subgroup's review of collateral and FAS 140 in its entirety.
104. FAS 140 provides the following guidance:

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 27 and 28).

b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29-34).

c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47-49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (paragraphs 50-54).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 61-67), beneficial interests in assets transferred to a qualifying SPE in a securitization (paragraphs 73-84), and retained undivided interests (paragraphs 58 and 59)

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 56-60).

11. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

a. Derecognize all assets sold

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 56, 57, and 61-67)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 68-70) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 71 and 72)

d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).
Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it transfers the assets to a qualifying SPE in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 61-64).

Financial Assets Subject to Prepayment

14. Interest-only strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended (paragraph 362).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.
   a. If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) shall reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.
   b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this Statement.
   c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset, and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.
   d. Except as provided in paragraph 15(c), the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:
a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Disclosures

17. An entity shall disclose the following:

a. For collateral:
   (1) If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
   (2) If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 15(a), the carrying amount and classification of those assets as of the date of the latest statement of financial position presented
   (3) If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of Statement 125, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of Statement 125 solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:
   (1) The amounts of servicing assets or liabilities recognized and amortized during the period
   (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
   (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 63
   (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):
   (1) Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)
   (2) The characteristics of securitizations (a description of the transferor’s continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations
(3) The key assumptions used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable)

(4) Cash flows between the securitization SPE and the transferor, unless reported separately elsewhere in the financial statements or notes (including proceeds from new securitizations, proceeds from collections reinvested in revolving-period securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained)

g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):

(1) Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)

(2) The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable)

(3) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under (2) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test

(4) For the securitized assets and any other financial assets that it manages together with them:

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period

(b) Delinquencies at the end of the period

(c) Credit losses, net of recoveries, during the period

Disclosure of average balances during the period is encouraged, but not required.

Implementation Guidance

18. Appendix A describes certain provisions of this Statement in more detail and describes their application to certain types of transactions. Appendix A is an integral part of the standards provided in this Statement.

Effective Date and Transition

19. Except as provided in paragraphs 20–25, this Statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. This Statement shall be applied prospectively, except as provided in paragraphs 20, 21, 23, and 24. Earlier or retroactive application of this Statement is not permitted.

20. For each servicing contract in existence before January 1, 1997, previously recognized servicing rights and “excess servicing” receivables that do not exceed contractually specified servicing fees shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset or liability. Previously recognized servicing receivables that exceed contractually specified servicing fees shall be reclassified as interest-only strips receivable. Thereafter, the subsequent measurement provisions of this Statement shall be applied to the servicing assets or liabilities for those servicing contracts (paragraph 63) and to the interest-only strips receivable (paragraph 14).
21. The provisions of paragraph 14 and the amendment to Statement 115 (paragraph 362) shall be effective for financial assets held on or acquired after January 1, 1997.

22. Paragraphs 17(f) and 17(g) shall be effective for financial statements for fiscal years ending after December 15, 2000. The information required to be disclosed about securitizations of financial assets during the period that are accounted for as sales need not be reported for periods ending on or before December 15, 2000, for which an income statement is presented for comparative purposes.

23. Collateral previously recognized in financial statements in accordance with the requirements of paragraphs 15(a)(ii) and 15(b) of Statement 125 that is no longer to be recognized in accordance with paragraph 15 of this Statement shall no longer be recognized in financial statements for fiscal years ending after December 15, 2000, and financial statements for previous periods presented for comparative purposes shall be restated accordingly. The requirements for reclassification of certain assets in paragraph 15(a) of this Statement and for disclosure about collateral pledged and accepted in paragraphs 17(a)(2) and 17(a)(3) shall be effective for financial statements for fiscal years ending after December 15, 2000; that information need not be reported for periods ending on or before December 15, 2000, for which a statement of financial position is presented for comparative purposes.

24. Assets transferred on or before March 31, 2001, and transfers of assets after that date required by commitments made before that date to transferees or beneficial interest holders (BIHs) other than the transferor, its affiliates, 12 or its agents shall continue to be accounted for under the previous accounting standards for transfers of assets that applied when the transferor made or committed to those transfers. Transfers of assets after that date, unless required by commitments made before that date to transferees or BIHs unrelated to the transferor, shall be subject to all the provisions of this Statement.

25. A formerly qualifying SPE that fails to meet one or more conditions for being a qualifying SPE under this Statement shall continue to be considered a qualifying SPE if it maintains its qualifying status under previous accounting standards, does not issue new beneficial interests after the effective date, and does not receive assets it was not committed to receive (through a commitment to BIHs unrelated to the transferor) before the effective date. Otherwise, the formerly qualifying SPE and assets transferred to it shall be subject to other consolidation policy standards and guidance and to all the provisions of this Statement.

Appendix A: IMPLEMENTATION GUIDANCE

Introduction

26. This appendix describes certain provisions of this Statement in more detail and describes how they apply to certain types of transactions. This appendix discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this Statement. This appendix is an integral part of the standards provided in this Statement.

Isolation beyond the Reach of the Transferor and Its Creditors

27. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if
the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any consolidated affiliate of the transferor that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 83(c)).

28. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 80-84). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

29. Sale accounting is allowed under paragraph 9(b) only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer's business or someone that the loan customer might consider an undesirable creditor. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

30. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

31. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor's Rights or Obligations to Reacquire Transferred Assets

32. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under
paragraph 9(b). For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 9(b).

33. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets, as discussed in paragraphs 50–54, thus precluding sale accounting under paragraph 9(c)(2). 15

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

34. The considerations in paragraphs 29–32, about conditions that may or may not constrain a transferee that is not a qualifying SPE from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a BIH from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

35. A qualifying SPE 16 is a trust or other legal vehicle that meets all of the following conditions:
   a. It is demonstrably distinct from the transferor (paragraph 36).
   b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).
   c. It may hold only:
      (1) Financial assets transferred to it that are passive in nature (paragraph 39)
      (2) Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40)
      (3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE
      (4) Servicing rights related to financial assets that it holds
      (5) Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 41)
(6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:

(1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)

(2) Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder’s beneficial interest back to the SPE (paragraph 44)

(3) Exercise by the transferor of a call or ROAP specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 51-54 and 85-88)

(4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 45).

Need to Be Demonstrably Distinct from the Transferor

36. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either (a) at least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents or (b) the transfer is a guaranteed mortgage securitization. 17 An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

37. The powers of the SPE must be limited to those activities allowed by paragraph 35 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

38. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 9(b) are then met by the SPE itself and the conditions in paragraphs 9(a) and 9(c) continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 55).

Limits on What a Qualifying SPE May Hold

39. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing (paragraph 61). An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control or
significant influence (as defined in generally accepted accounting principles for consolidation policy and for the equity method, respectively) over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE’s assets.

40. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:
   a. Is entered into (1) when the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents or (2) when a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold
   b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently
   c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

41. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets. A qualifying SPE also may hold the residual value of a sales-type or a direct financing lease only to the extent that it is guaranteed at the inception of the lease either by the lessee or by a third party financially capable of discharging the obligations that may arise from the guarantee (paragraph 89).

Limits on Sales or Other Dispositions of Assets

42. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them—include requirements to dispose of transferred assets in response to:
   a. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee
   b. A default by the obligor
   c. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating
   d. The involuntary insolvency of the transferor
   e. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

43. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those
transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure

b. A requirement to dispose of marketable equity securities upon a specified decline from their “highest fair value” if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE

c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

44. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets

b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put)

c. New beneficial interests in those assets.

45. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Qualifying SPEs and Consolidated Financial Statements

46. A qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates.

Maintaining Effective Control over Transferred Assets

Agreement to Repurchase or Redeem Transferred Assets

47. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets under paragraph 9(c)(1), and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 48).

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 49).

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

d. The agreement is entered into concurrently with the transfer.

48. To be substantially the same, 18 the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield)

d. Identical contractual interest rates

e. Similar assets as collateral

f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

49. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

50. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 9(c)(2). For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor’s maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor’s maintaining effective control, because it is the issuer rather than the transferor who holds the call.

51. If the transferee is a qualifying SPE, it has met the conditions in paragraph 35(d) and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor’s effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor’s unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

52. A call that is attached to transferred assets maintains the transferor’s effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor’s effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor’s effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

53. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a
right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

54. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited (paragraph 87(a)), because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guarantee (paragraph 42(a)) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase that beneficial interest (paragraph 44(b)), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor’s Regaining Control of Assets Sold

55. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor’s regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 9 are no longer met. Such a change, unless it arises solely from either the initial application of this Statement or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 11). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 38). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

56. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

57. Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).
**Fair Values**
Cash proceeds $1,050
Interest rate swap 40
Call option 70
Recourse obligation 60

**Net Proceeds**
Cash received $1,050
Plus: Call option 70
Interest rate swap 40
Less: Recourse obligation (60)
Net proceeds $1,100

**Gain on Sale**
Net proceeds $1,100
Carrying amount of loans sold $1,000
Gain on sale 100

**Journal Entry**
Cash 1,050
Interest rate swap 40
Call option 70
Loans 1,000
Recourse obligation 60
Gain on sale 100
To record transfer

Retained Interests

58. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. Allocation procedures shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 56.

59. If the retained interests are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.

Illustration—Recording Transfers of Partial Interests

60. Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.
Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Value</td>
<td></td>
</tr>
<tr>
<td>Nine-tenths interest sold</td>
<td>$ 990</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>110</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,100</td>
</tr>
</tbody>
</table>

Gain on Sale
Net proceeds                 $ 990
Carrying amount of loans sold 900
Gain on sale                  $ 90

Journal Entry
Cash 990
Loans 900
Gain on sale 90
To record transfer

Servicing Assets and Liabilities

61. Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

62. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, with only one exception. (That exception is if the transferor transfers the assets in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced.) Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. (A servicing asset may become a servicing liability, or vice versa, if circumstances change, and the initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities.)

63. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:
a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).

b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 58–60, and 68-72).

c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).

d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11(b), 11(c), and 68-72).

e. Account separately for rights to future interest income from the serviced assets that exceed contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.

f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).

g. Subsequently evaluate and measure impairment of servicing assets as follows:
   (1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location.
   (2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.
   (3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).

h. Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows from the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

64. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset. For example, if in the transaction illustrated in paragraph 57 the transferor had agreed to service the loans without explicit compensation and it estimated the fair value of that servicing obligation at $50, net proceeds would be reduced to $1,050, gain on sale would be reduced to $50, and the transferor would report a servicing liability of $50.

Illustration—Sale of Receivables with Servicing Retained

65. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is
considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is $1,100. The fair value of the servicing asset is $40.

### Fair values
- Cash proceeds: $1,000
- Servicing asset: 40
- Interest-only strip receivable: 60

### Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Fair Value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,000</td>
<td>91.0%</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
<td>3.6%</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
<td>5.4%</td>
</tr>
<tr>
<td>Total</td>
<td>$1,100</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

### Gain on Sale
- Net proceeds: $1,000
- Carrying amount of loans sold: 910
- Gain on sale: $90

### Journal Entries
- Cash 1000
  - Loans 910
  - Gain on sale 90
- To record transfer
  - Servicing asset 36
  - Interest-only strip receivable 54
  - Loans 90
- To record servicing asset and interest-only strip receivable
  - Interest-only strip receivable 6
  - Equity 6
- To begin to subsequently measure interest-only strip receivable like an available-for-sale security (paragraph 14)

66. The previous illustration demonstrates how a transferor would account for a simple sale or securitization in which servicing is retained. Company C might instead transfer the financial assets to a corporation or a trust that is a qualifying SPE. The qualifying SPE then securitizes the loans by selling beneficial interests to the public. The qualifying SPE pays the cash proceeds to the original transferor, which accounts for the transfer as a sale and derecognizes the financial assets assuming that the criteria in paragraph 9 are met. Securitizations often combine the elements shown in paragraphs 57, 60, and 65, as illustrated below.

Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

67. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to
the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans.

**Fair values**

<table>
<thead>
<tr>
<th>Item</th>
<th>Fair Value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$900</td>
<td>83</td>
<td>$830</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>8</td>
<td>80</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>9</td>
<td>90</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>90</td>
<td>8</td>
<td>80</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>100</td>
<td>9</td>
<td>90</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,100</strong></td>
<td><strong>100</strong></td>
<td><strong>$1,000</strong></td>
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**Net Proceeds**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$900</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
</tr>
<tr>
<td><strong>Net proceeds</strong></td>
<td><strong>$910</strong></td>
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**Carrying Amount Based on Relative Fair Values**

<table>
<thead>
<tr>
<th>Item</th>
<th>Fair Value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest sold</td>
<td>$910</td>
<td>83</td>
<td>$830</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>90</td>
<td>8</td>
<td>80</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>100</td>
<td>9</td>
<td>90</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,100</strong></td>
<td><strong>100</strong></td>
<td><strong>$1,000</strong></td>
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**Gain on Sale**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$910</td>
</tr>
<tr>
<td>Carrying amount of loans sold</td>
<td>830</td>
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<tr>
<td>Gain on sale</td>
<td>$80</td>
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**Journal Entries**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>900</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
</tr>
<tr>
<td>Loans</td>
<td>830</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>80</td>
</tr>
<tr>
<td>To record transfer</td>
<td></td>
</tr>
<tr>
<td>Servicing asset</td>
<td>80</td>
</tr>
<tr>
<td>Loans</td>
<td>80</td>
</tr>
<tr>
<td>To record servicing asset</td>
<td></td>
</tr>
</tbody>
</table>

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.

**Fair Value**

68. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price.
69. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value, the objective is to estimate the value of the assets required currently to (a) settle the liability with the holder or (b) transfer a liability to an entity of comparable credit standing.

70. Estimates of expected future cash flows, if used to estimate fair value, shall be based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered either directly, if applying an expected cash flow approach, or indirectly through the risk-adjusted discount rate, if determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Values

71. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:
   a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred
   b. The amount that would be recognized in accordance with FASB Statement No. 5, Accounting for Contingencies, as interpreted by FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

72. Company E sells loans with a carrying amount of $1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

<table>
<thead>
<tr>
<th>Fair Values</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>XX*</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>XX*</td>
</tr>
<tr>
<td>Fair value of loans transferred</td>
<td>1,100</td>
<td>1,100</td>
</tr>
</tbody>
</table>

* Not practicable to estimate fair value
### Net Proceeds

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
<td>XX</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,060</td>
<td>$1,120</td>
</tr>
</tbody>
</table>

### Carrying Amount Based on Relative Fair Values (Case 1)

<table>
<thead>
<tr>
<th></th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,060</td>
<td>100</td>
<td>$1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$1,060</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

### Carrying Amount Based on Relative Fair Values (Case 2)

<table>
<thead>
<tr>
<th></th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,120</td>
<td>97</td>
<td>$970</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
<td>3</td>
<td>30</td>
</tr>
<tr>
<td>Total</td>
<td>$1,160</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

### Journal Entries

#### Case 1

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,050</td>
<td>1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0*</td>
<td>30</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Loans</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>150†</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>60</td>
<td>0</td>
</tr>
<tr>
<td>To record transfer</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.
† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

### Securitizations

73. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or salestype leases) also are common. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this Statement.

74. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.
75. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

76. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Revolving-Period Securitizations

77. The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract's value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

78. Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving-period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized.

79. Revolving-period securitizations may use either a discrete trust, used for a single securitization, or a master trust, used for many securitizations. To achieve another securitization using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors. Adding receivables to a master trust, in itself, is neither a sale nor a secured borrowing under paragraph 9, because that transfer only increases the transferor's beneficial interest in the trust's assets. A sale or secured borrowing does not occur until the transferor receives consideration other than beneficial interests in the transferred assets. Transfers that result in an exchange of cash, that is, either transfers that in essence replace previously transferred receivables that have been collected or sales of beneficial interests to outside investors, are transfers in exchange for consideration other than beneficial interests in the transferred assets and thus are accounted for as sales (if they satisfy all the criteria in paragraph 9) or as secured borrowings.

Isolation of Transferred Assets in Securitizations

80. A securitization carried out in one transfer or a series of transfers may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

81. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The
trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

82. In other securitizations, a similar corporation transfers financial assets to an SPE in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies only if both (a) the credit enhancement from the junior interest is sufficient and (b) the transferor is highly rated. Depending on facts and circumstances, the Board understands that those “single-step” securitizations often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 113). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

83. Still other securitizations use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those “two-step” structures:
   a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide “excessive” credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.
   b. Second, the special-purpose corporation transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.
   c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

The Board understands that the "two-step" securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

84. The powers of receivers for entities not subject to the U.S. Bankruptcy Code (for example, banks subject to receivership by the FDIC) vary considerably, and therefore some
receivers may be able to reach financial assets transferred under a particular arrangement and others may not. A securitization may isolate transferred assets from a transferor subject to such a receiver and its creditors even though it is accomplished by only one transfer directly to an SPE that issues beneficial interests to investors and the transferor provides credit or yield protection. For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.


85. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). Whether a ROAP precludes sale accounting depends on whether the ROAP results in the transferor’s maintaining effective control over specific transferred assets (paragraphs 9(c)(2) and 51-54).

86. The following are examples of ROAPs that preclude transfers from being accounted for as sales:
   a. An unconditional ROAP or repurchase agreement that allows the transferor to specify the assets that may be removed, because such a provision allows the transferor unilaterally to remove specific assets
   b. A ROAP conditioned on a transferor’s decision to exit some portion of its business, because whether it can be triggered by canceling an affinity relationship, spinning off a business segment, or accepting a third party’s bid to purchase a specified (for example, geographic) portion of the transferor’s business, such a provision allows the transferor unilaterally to remove specific assets.

87. The following are examples of ROAPs that do not preclude transfers from being accounted for as sales:
   a. A ROAP for random removal of excess assets, if the ROAP is sufficiently limited so that the transferor cannot remove specific transferred assets, for example, by limiting removals to the amount of the transferor’s retained interest and to one removal per month
   b. A ROAP for defaulted receivables, because the removal would be allowed only after a third party’s action (default) and could not be caused unilaterally by the transferor
   c. A ROAP conditioned on a third-party cancellation, or expiration without renewal, of an affinity or private-label arrangement, because the removal would be allowed only after a third party’s action (cancellation) or decision not to act (expiration) and could not be caused unilaterally by the transferor.

88. A ROAP that can be exercised only in response to a third party’s action that has not yet occurred does not maintain the transferor’s effective control over assets potentially subject to that ROAP. However, when a third party’s action (such as default or cancellation) or decision not to act (expiration) occurs that allows removal of assets to be initiated solely by the transferor, the transferor must recognize any assets subject to the ROAP, whether the ROAP is exercised or not. If the ROAP is exercised, the assets are recognized because the transferor has reclaimed the assets. If the ROAP is not exercised, the assets are recognized because the transferor now unilaterally causes the qualifying SPE to return those specific assets and, therefore, the transferor once again has effective control over those transferred assets (paragraph 55).

Securities Lending Transactions

91. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer’s failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide
"collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

92. In some securities lending transactions, the criteria in paragraph 9 are met, including the effective control criterion in paragraph 9(c), and consideration other than beneficial interests in the transferred assets is received. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the cash "collateral" and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

93. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 47-49). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed and reclassified as set forth in paragraph 15(a), and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

94. The transferor of securities being "loaned" accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for cash received.

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

95. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

**Facts**
- Transferor's carrying amount and fair value of security loaned: $1,000
- Cash "collateral": 1,020
- Transferor's return from investing cash collateral at a 5 percent annual rate: 5
- Transferor's rebate to the securities borrower at a 4 percent annual rate: 4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.
**Journal Entries for the Transferor**

*At inception:*
- Cash 1,020
  - Payable under securities loan agreements 1,020
  To record the receipt of cash collateral

- Securities pledged to creditors 1,000
  - Securities 1,000
  To reclassify loaned securities that the secured party has the right to sell or repledge

- Money market instrument 1,020
  - Cash 1,020
  To record investment of cash collateral

*At conclusion:*
- Cash 1,025
  - Interest 5
  - Money market instrument 1,020
  To record results of investment

- Securities 1,000
  - Securities pledged to creditors 1,000
  To record return of security

- Payable under securities loan agreements 1,020
  - Interest (“rebate”) 4
    - Cash 1,024
  To record repayment of cash collateral plus interest

**Journal Entries for the Transferee**

*At inception:*
- Receivable under securities loan agreements 1,020
  - Cash 1,020
  To record transfer of cash collateral

- Cash 1,000
  - Obligation to return borrowed securities 1,000
  To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

*At conclusion:*
- Obligation to return borrowed securities 1,000
  - Cash 1,000
  To record the repurchase of securities borrowed

- Cash 1,024
  - Receivable under securities loan agreements 1,020
  - Interest revenue (“rebate”) 4
  To record the receipt of cash collateral and rebate interest

**Repurchase Agreements and "Wash Sales"**

96. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor (“repo party”) transfers a security to a transferee (“repo counterparty"
Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

97. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

98. If the criteria in paragraph 9 are met, including the criterion in paragraph 9(c)(1), the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

99. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

100. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 48) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

101. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Loan Syndications

102. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

103. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is simply functioning as a servicer and, therefore, shall not recognize the aggregate loan as an asset.
Loan Participations

104. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

105. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor ("originating lender") continues to service the loan. The transferee ("participating entity") may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

106. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 9 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor if other potential willing buyers exist is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor presumptively receives a more than trivial benefit, has not relinquished control over the loan, and shall account for the transfers as secured borrowings.

Factoring Arrangements

112. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 9 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

113. In a transfer of receivables with recourse, the transferor provides the transferee with full or limited recourse. The transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. The effect of a recourse provision on the application of paragraph 9 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred assets beyond the reach of the transferor and its creditors, but transfers with limited recourse may. A transfer of receivables with recourse shall be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation, if the criteria in paragraph 9 are met. Otherwise, a transfer of receivables with recourse shall be accounted for as a secured borrowing.

Extinguishments of Liabilities

114. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.
RELEVANT LITERATURE

Statutory Accounting

- Statement of Statutory Accounting Principles No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- Statement of Statutory Accounting Principles No. 33—Securitization
- Statement of Statutory Accounting Principles No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- Purposes and Procedures Manual of the NAIC Securities Valuation Office

Generally Accepted Accounting Principles

- FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position
- FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement
- FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold
- FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues
- FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios
- FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement
- FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights
- FASB Emerging Issues Task Force No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments
EXHIBIT A - GLOSSARY

Asset Securitization

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial Interest Holder (“BIH”)

Holder of beneficial interests

Cleanup Call

An option held by the servicer, which may be the transferor, to purchase transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome in relation to the benefits or servicing.

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative Financial Instrument

A derivative instrument (as defined in SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions) that is a financial instrument (refer to SSAP No. 27, paragraph 2).

Embedded Call (See Issue Paper on FAS 140 paragraphs 50 and 52)

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.
Financial Liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Guaranteed Mortgage Securitization

A securitization of mortgage loans which includes a substantive guarantee by a third party.

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Residual

Residuals are a class of retained or purchased beneficial interests that have rights to the last cash flows from the pool of securitized assets and are not rated by a NRSRO. Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss.

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.
Servicing Liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided Interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unrestricted Collateral

Securities received that may be sold or repledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.

Unilateral Ability (See Issue Paper on FAS 140 paragraphs 50 and 51)

A capacity for action not dependent on the actions (or failure to act) of any other party.
EXHIBIT B - ILLUSTRATIONS

1. Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

**Fair Values**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
</tr>
</tbody>
</table>

**Net Proceeds**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>40</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

**Gain on Sale**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$1,100</td>
</tr>
<tr>
<td>Carrying amount of loans sold</td>
<td>$ 100</td>
</tr>
</tbody>
</table>

**Journal Entry**

Cash 1,050
Interest rate swap 40
Call option 70
Loans 1,000
Recourse obligation 60
Gain on sale 100

To record transfer

2. Illustration—Recording Transfers of Partial Interests

Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

**Fair values**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds for nine-tenths sold</td>
<td>$990</td>
</tr>
<tr>
<td>One-tenth interest retained (\frac{[($990 \div 9/10) \times 1/10]}{100})</td>
<td>110</td>
</tr>
</tbody>
</table>
Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of Total</td>
<td>Fair Value</td>
</tr>
<tr>
<td>Nine-tenths interest sold</td>
<td>$ 990</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>110</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,100</td>
</tr>
</tbody>
</table>

Gain on Sale
- Net proceeds: $ 990
- Carrying amount of loans sold: 900
- Gain on sale: $ 90

Journal Entry
- Cash: 990
- Loans: 900
- Gain on sale: 90
To record transfer

3. Illustration—Sale of Receivables with Servicing Retained

Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is $1,100. The fair value of the servicing asset is $40.

Fair Values
- Cash proceeds: $1,000
- Servicing asset: 40
- Interest-only strip receivable: 60

Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of Total</td>
<td>Fair Value</td>
</tr>
<tr>
<td>Loans sold</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,100</td>
</tr>
</tbody>
</table>

Gain on Sale
- Net proceeds: $ 1000
- Carrying amount of loans sold: 910
- Gain on sale: $ 90
### Journal Entries

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>Loans</td>
<td>910</td>
<td></td>
</tr>
<tr>
<td>Gain on sale</td>
<td>90</td>
<td></td>
</tr>
</tbody>
</table>

*To record transfer*

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Servicing asset</td>
<td>36</td>
<td></td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>54</td>
<td></td>
</tr>
<tr>
<td>Loans</td>
<td>90</td>
<td></td>
</tr>
</tbody>
</table>

*To record servicing asset and interest-only strip receivable*

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest-only strip receivable</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>6</td>
<td></td>
</tr>
</tbody>
</table>

*To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140 paragraph 14)*

### 4. Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans.

### Fair Values

<table>
<thead>
<tr>
<th>Description</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$900</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>90</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>100</td>
</tr>
</tbody>
</table>

### Net Proceeds

<table>
<thead>
<tr>
<th>Description</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$900</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$910</td>
</tr>
</tbody>
</table>

### Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage Of Total</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest sold</td>
<td>83</td>
<td>$830</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>8</td>
<td>80</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>9</td>
<td>90</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>
**Gain on Sale**

Net proceeds $ 910  
Carrying amount of loans sold 830  
Gain on sale $ 80

**Journal Entries**

Cash 900  
Call option 70  
Loans 830  
Recourse obligation 60  
Gain on sale 80  

*To record transfer*

Servicing asset 80  
Loans 80  

*To record servicing asset*

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.

5. **Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value**

Company E sells loans with a carrying amount of $1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

<table>
<thead>
<tr>
<th><strong>Fair Values</strong></th>
<th><strong>Case 1</strong></th>
<th><strong>Case 2</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>XX*</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>XX*</td>
</tr>
<tr>
<td>Fair value of loans transferred</td>
<td>$1,100</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

* Not practicable to estimate fair value

<table>
<thead>
<tr>
<th><strong>Net Proceeds</strong></th>
<th><strong>Case 1</strong></th>
<th><strong>Case 2</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
<td>XX</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,060</td>
<td>$1,120</td>
</tr>
</tbody>
</table>
Carrying Amount Based on Relative Fair Values (Case 1)

<table>
<thead>
<tr>
<th></th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,060</td>
<td>100</td>
<td>$1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,060</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Carrying Amount Based on Relative Fair Values (Case 2)

<table>
<thead>
<tr>
<th></th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,120</td>
<td>97</td>
<td>$970</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
<td>3</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,160</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Journal Entries**

**Case 1**
- **Cash**: 1,050
- **Servicing asset**: 0
- **Call option**: 70
- **Loans**: 1,000
- **Recourse obligation**: 60
- **Gain on sale**: 60

**Case 2**
- **Cash**: 1,050
- **Servicing asset**: 30
- **Call option**: 70
- **Loans**: 1,000
- **Recourse obligation**: 150
- **Gain on sale**: 0

To record transfer

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.
† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

6. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

**Facts**
- **Transferor’s carrying amount and fair value of security loaned**: $1,000
- **Cash “collateral”**: 1,020
- **Transferor’s return from investing cash collateral at a 5 percent annual rate**: 5
- **Transferor’s rebate to the securities borrower at a 4 percent annual rate**: 4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

**Journal Entries for the Transferor**

**At inception:**
- **Cash**: 1,020
- **Payable under securities loan agreements**: 1,020

To record the receipt of cash collateral
Securities pledged to creditors 1,000
Securities 1,000

To reclassify loaned securities that the secured party has the right to sell or repledge

Money market instrument 1,020
Cash 1,020

To record investment of cash collateral

At conclusion:
Cash 1,025
Interest 5
Money market instrument 1,020

To record results of investment

Securities 1,000
Securities pledged to creditors 1,000

To record return of security

Payable under securities loan agreements 1,020
Interest ("rebate") 4
Cash 1,024

To record repayment of cash collateral plus interest

Journal Entries for the Transferee

At inception:
Receiveable under securities loan agreements 1,020
Cash 1,020

To record transfer of cash collateral

Cash 1,000
Obligation to return borrowed securities 1,000

To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

At conclusion:
Obligation to return borrowed securities 1,000
Cash 1,000

To record the repurchase of securities borrowed

Cash 1,024
Receiveable under securities loan agreements 1,020
Interest revenue ("rebate") 4

To record the receipt of cash collateral and rebate interest
Statutory Issue Paper No. 123

Accounting for Pensions, A Replacement of SSAP No. 8

STATUS:
Finalized September 15, 2003

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for employers’ pension obligations is provided in Statement of Statutory Accounting Principles (SSAP) No. 8—Pensions (SSAP No. 8). This issue paper supersedes the conclusions reached in SSAP No. 8 and incorporates the guidance in INT 99-24: Accounting for Restructuring Charges, INT 99-26: Offsetting Pension Assets and Liabilities, INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations, INT 01-17: Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans, as well as some of the guidance in INT 02-18: Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9 d.v. and 9f.

2. The changes made in this issue paper regarding the accounting treatment of the additional minimum pension liability will create a nonsubstantive change to SSAP No. 72—Surplus and Quasi-reorganizations. Unassigned funds (surplus) will include changes in the additional minimum pension liability.

3. Generally Accepted Accounting Principles (GAAP) guidance for these issues is established in Financial Accounting Standards Board (FASB) Statement No. 87, Employers’ Accounting for Pensions (FAS 87), FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits (FAS 88), FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits (FAS 132), and FASB Statement No. 130, Other Comprehensive Income (FAS 130).

4. The purpose of this issue paper is to establish statutory accounting principles for an 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

5. A defined benefit plan defines the amount of the pension benefit that will be provided to the plan participant at retirement or termination. For such benefit plans, reporting entities shall adopt FAS 87 with modifications to exclude non-vested employees and to account for the additional minimum pension liability. Therefore, the cost related to services rendered prior to becoming eligible and vested in the plan are recognized as a component of the net periodic pension cost in the period the employee becomes vested. Any intangible asset or prepaid expense, other than the intangible asset associated with the transition obligation recorded as of January 1, 2001, resulting from adoption of the provisions of this issue paper shall be considered a nonadmitted asset, as such an asset cannot be readily converted to cash to satisfy policyholder obligations. This is consistent with the definition of assets and nonadmitted assets set forth in SSAP No. 4—Assets and Nonadmitted Assets.
6. If the accumulated benefit obligation exceeds the fair value of plan assets, the reporting entity shall recognize a liability (including unfunded accrued pension cost) that is at least equal to the unfunded accumulated benefit obligation. Recognition of an additional minimum liability is required if an unfunded accumulated benefit obligation exists and (a) a prepaid pension cost asset has been recognized as a nonadmitted asset, (b) the liability already recognized as unfunded accrued pension cost is less than the unfunded accumulated benefit obligation, or (c) no accrued or prepaid pension cost has been recognized.

7. If an additional minimum liability is recognized an equal amount shall be recognized as an intangible asset, provided that the asset recognized shall not exceed the amount of unrecognized prior service cost (unrecognized prior service cost shall include unamortized incremental liability). If an intangible asset generated by the additional minimum liability is recognized, only that portion in excess of the unamortized incremental liability associated with the transition shall be nonadmitted. If an additional liability required to be recognized exceeds unrecognized prior service cost, the excess (which would represent a net loss not yet recognized as net periodic pension cost) shall be reported as a component of unassigned funds (surplus), net of any tax benefits that result from considering such losses as temporary differences for purposes of applying the provisions of SSAP No. 10—Income Taxes.

8. When a new determination of the amount of additional liability is made, the related intangible asset and the balance accumulated in unassigned funds (surplus) shall be eliminated or adjusted as necessary.

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

Defined Contribution Plans

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

11. For defined contribution plans, the reporting entity shall expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants' accounts made prior to vesting shall be treated as prepaid expenses, and shall be nonadmitted. Contributions required after participants terminate or retire shall be accrued and an expense shall be recorded over the working lives of the participants beginning at the date the participant initially vests in plan contributions.
12. Certain defined contribution plans may define the employer’s contribution as a percentage of the plan participants’ individual compensation rather than as a specific dollar amount which is allocated among the plan participants. If an employer’s contributions to a defined contribution plan are in excess of those required under the plan and required to be allocated to individual participants, such amounts are recorded as a prepaid expense and nonadmitted under statutory accounting principles.

Disclosures

13. The following disclosures shall be made for defined benefit pension plans for which the reporting entity is directly liable:

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

b. The amount of the pension obligation for non-vested employees as of the most recent actuarial valuation date;

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

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

   i. The amount of any unamortized prior service cost;

   ii. The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value);

   iii. The amount of any remaining unamortized, unrecognized net obligation or net asset existing at the initial date of application of this statement;

   iv. The net pension or other postretirement benefit prepaid assets or accrued liabilities; and

   v. Any intangible asset;

e. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized incremental liability or incremental asset (see paragraph 20), the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment;

f. The amount included in unassigned funds (surplus) for the period arising from a change in the additional minimum pension liability recognized pursuant to paragraph 7;
g. On a weighted-average basis, the following assumptions used in the accounting for the plan: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets;

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

i. If applicable, any alternative amortization method used to amortize prior service amounts or unrecognized net gains and losses pursuant to paragraphs 26 and 33 of FAS 87;

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

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

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

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

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

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

16. Refer to the preamble for further discussion regarding disclosure requirements.

Consolidated/Holding Company Plans

17. The employees of many reporting entities are members of a plan sponsored by a parent company or holding company. A reporting entity who participates in these plans and is not directly liable for obligations under the plan shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for obligations under the plan, then the requirements outlined above in paragraphs 5 to 13 and 20 to 24 of this issue paper shall be applied.
DISCUSSION

18. The conclusions in paragraphs 5 to 13 and 20 to 24 adopt FAS 87, FAS 88, and FAS 132 with certain modifications. Those modifications and additional information from nullified interpretations are listed below:

   a. Calculation of the pension obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts;

   b. A liability for ancillary benefits (primarily death and disability benefits) shall be accrued prior to the triggering event of these benefits for purposes of Projected Benefit Obligation (PBO) and Service Cost (SC) in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

   c. A liability for protected, nonvested benefits shall be accrued for purposes of PBO and SC in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

   d. A liability for nonvested, nonqualified benefits prior to retirement or when there is no longer a substantial risk of forfeiture, shall be accrued for purposes of PBO and SC in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

   e. Entities shall perform actuarial analysis consistent with the three month guideline contained within FAS 87;

   f. A reporting entity that utilizes an actuarial valuation as of a date prior to the financial statement date to measure plan assets and obligations, and determines that an additional minimum liability is required to be established in accordance with paragraph 37 of FAS 87, and if the reporting entity contributes amounts to the plan to fund that additional minimum liability prior to the financial statement date, such amount funded may be used to reduce the additional minimum liability recognized in the reporting entity’s financial statements;

   g. It is not acceptable statutory accounting practice to offset pension or postretirement benefits other than pensions (OPEB) liability generated by one plan against the prepaid asset of another plan;

   h. Reporting entities may downsize their operations and in doing so, often offer severance pay and other benefits to displaced workers. Costs associated with downsizing shall be recorded as an expense in the financial statements;

   i. The prepaid asset which results from an excess of the fair value of plan assets over the pension obligation shall be recorded as a nonadmitted asset;

   j. Any intangible asset offsetting the minimum pension liability (excluding the unamortized incremental liability associated with transition) shall be nonadmitted and charged to surplus;

   k. Any additional minimum liability in excess of unrecognized prior service cost that is reported as a component of unassigned funds (surplus), shall be classified as an aggregate write-in for gains and losses in surplus;
1. As of January 1, 2001 the pension obligation or asset not previously recognized related to vested employees may be recorded immediately or may be amortized over future periods;

m. Paragraphs 36 through 38 of FAS 87 are adopted with modifications described in paragraph 7 of this issue paper;

n. A net gain (net of excess tax surcharge) resulting from the settlement or curtailment of a pension plan is not recognized until the proceeds are received by the reporting entity;

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

p. For the disclosures relating to the initial date of application in paragraph 5 of FAS 132, January 1, 2001 shall be considered the initial date of application; and

q. Pension disclosures relating to other comprehensive income in paragraph 5 of FAS 132 shall be made for unassigned funds (surplus) on a statutory basis.

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

Effective Date and Transition

20. As of January 1, 2001, the transition obligation or asset shall be determined as the difference between the vested projected benefit obligation and the fair value of plan assets. If prior to the effective date of January 1, 2001, the reporting entity has adopted FAS 87 for statutory accounting purposes, the transition obligation or asset calculated above shall be compared to those amounts previously recorded under FAS 87. The difference between these amounts represents an incremental asset or liability. If the reporting entity has not previously adopted FAS 87 for statutory accounting purposes, the entire transition asset or obligation represents the incremental asset or liability.

21. As of January 1, 2001, if the reporting entity calculates an incremental liability, this liability shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental liability as a direct charge to surplus;

b. Alternatively, the reporting entity may elect to amortize the incremental liability as a component of net periodic pension cost over a period not to exceed 20 years.

22. As of January 1, 2001, if the reporting entity calculates an incremental asset, this asset shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental asset as a direct credit to surplus;

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

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

24. This issue paper is effective for years ending on or after, December 31, 2003. SSAP No. 8 applies to the calculation of the transition obligation in accordance with the adoption of FAS 87 for periods prior to the adoption of this statement. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. For reporting entities that expensed the additional minimum pension liability through income prior to January 1, 2004 under SSAP No. 8, if the additional minimum pension liability subsequently decreases because of factors such as asset value recovery, the reversal of the expense shall be through unassigned funds (surplus). Restatement of previously expensed additional minimum liability amounts through the income statement is not permitted.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
25. The following is excerpted from Interpretation 02-18

The working group reached a consensus to require reporting entities to recognize the entire minimum pension liability in the financial statement. Further, any intangible asset offsetting the minimum pension liability shall be nonadmitted and charged to surplus.

26. See Issue Paper No. 8 for additional statutory references

Generally Accepted Accounting Principles
27. The following is excerpted from FASB Statement No. 130, Other Comprehensive Income (FAS 130):

10. This Statement uses the term comprehensive income to describe the total of all components of comprehensive income, including net income.\(^4\) This Statement uses the term other comprehensive income to refer to revenues, expenses, gains, and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income. This Statement does not require that an enterprise use the terms comprehensive income or other comprehensive income in its financial statements, even though those terms are used throughout this Statement.\(^5\)

\(^4\) FAS130, Footnote 4--This Statement uses the term net income to describe a measure of financial performance resulting from the aggregation of revenues, expenses, gains, and losses that are not items of other comprehensive income as identified in this Statement. A variety of other terms such as net earnings or earnings may be used to describe that measure.

\(^5\) FAS130, Footnote 5--Paragraph 40 of Concepts Statement 5 states that "just as a variety of terms are used for net income in present practice, the Board anticipates that total nonowner changes in equity, comprehensive loss, and other equivalent terms will be used in future financial statements as names for comprehensive income."

28. See Issue Paper No. 8 for additional GAAP references

OTHER SOURCES OF INFORMATION

29. See Issue Paper No. 8 for Other Sources of Information
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 8—Pensions
- Issue Paper No. 3—Accounting Changes
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 8—Accounting for Pensions
- Minutes from the June 23, 1987, meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 15, 1987, meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the June 12, 1986, meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 8, 1986, meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- Employers’ Accounting for Postretirement Benefits Other Than Pensions—Field Test of the Statutory Proposal—prepared by the Codification Advisory Group, September 20, 1992
- INT 02-18: Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9 d.v. and 9.f.
- INT 01-1: Measurement Date for SSAP No. 8 Actuarial Valuations
- INT 01-17: Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans
- INT 99-24: Accounting for Restructuring Charges
- INT 99-26: Offsetting Pension Assets and Liabilities

Generally Accepted Accounting Principles
- FASB Statement No. 87, Employers’ Accounting for Pensions
- FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits
- FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits
- FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefits Obligation for a Defined Benefit Pension Plan
- FASB Emerging Issues Task Force No. 90-3, Accounting for Employers’ Obligations for Future Contributions to a Multiemployer Pension Plan
- FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits
- FASB Emerging Issues Task Force No. 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination
- FASB Statement No. 130, Other Comprehensive Income

State Regulations
- No additional guidance obtained from state statutes or regulations.
Other Sources of Information
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22, General Expenses and Taxes, Licenses and Fees
- Draft discussion material from previous Property/Casualty codification projects - Chapter on Non-Claim Operating Expenses
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Statutory Issue Paper No. 124

Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, An Amendment to SSAP No. 43—Loan-Backed and Structured Securities

STATUS:
Finalized December 2, 2007

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 43) requires that loan-backed and structured securities shall be revalued using new prepayment assumptions by utilizing either the prospective or retrospective adjustment methodologies. When calculating these new prepayment assumptions, SSAP No. 43 states that undiscounted cash flows should be utilized.

2. Concerns have been raised that an undiscounted cash flows approach for impairment analysis does not properly evaluate certain asset-backed or structured securities. These securities are subject to other than temporary impairment due to deterioration in the credit quality of the underlying securities which serve as the source of cash flow for the payment of interest, and, depending upon the structure of the security, in some cases may also serve as the source for a substantial portion of the return of principal. The issue is that other than temporarily impaired securities are not accurately identified or reported under SSAP No. 43 impairment analysis.

3. The purpose of this issue paper is to amend SSAP No. 43 to require the use of fair value for impairment analysis and subsequent valuation of loan-backed and structured securities, and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy.

SUMMARY CONCLUSION

4. This issue paper amends paragraphs 14 through 16 of SSAP No. 43 to the following:

14. 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 the prospective 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 security is determined to be other than temporarily impaired.

15. 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.
16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield (i.e., undiscouned estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined that the decline in fair value of the security is an other than temporary, impairment has occurred, then the cost basis of the security shall be written down to fair value, the undiscounted estimated future cash flows and the amount of the write down shall be accounted for as a realized loss. An interest related decline in value shall be considered other than temporary only when a reporting entity has the intent to sell the investment, at the reporting date, before recovery of the cost of the investment. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. Credit related other than temporary impairment losses shall be recorded through the AVR; interest related other than temporary impairment losses shall be recorded through the 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.

Effective Date and Transition

5. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2009. A change resulting from the adoption of the finalized SSAP shall be accounted for prospectively.

DISCUSSION

6. Two forms of asset-backed or structured securities, commonly referred to as principal protected securities and combination notes, pose a significant risk of credit related impairment. A typical principal protected security is structured such that cash and securities are deposited in a trust, with the trust issuing new securities on the basis of the deposited assets. The cash is used to purchase a zero coupon U.S. government strip (or similar low risk security) with the intent that it will accrete to an amount equal to the original principal of the structured security at maturity. The deposited higher risk securities support the payment of interest. In dynamically hedged structures, the allocation to the low risk securities varies throughout the life of the structured security based on the performance of the higher risk assets. In this type of structure, the higher risk assets may be supporting the interest payments as well as providing for a substantial portion, or potentially all, of the return of principal.

7. The allocation to the low risk strip is used as a hedge to advocate the position that the security is "principal protected" since the intent is for the investor to be “guaranteed” a return of principal at maturity. This position ignores the economic reality that in some structured security arrangements, particularly those that are dynamically hedged or leveraged, the initial value of the low risk strip may be a very small percentage of the principal value of the assets in the trust, with the balance being in residual tranches of higher risk securities.

8. Recently there have been a large number of residual tranches used in principal protected securities that have experienced significant declines in value purely as a result of the crystallization of credit risk. When the value of the residual securities in these structures is diminished, the market value of the structured security moves toward the present value of the low risk strip. Though the value of the structured securities has often been significantly impaired, in many cases, other than temporary
impairment recognition would not be required in the financial statements under an undiscounted cash flows approach to impairment analysis.

9. From an admitted asset perspective, in such an instance, a reporting entity with solvency or liquidity problems could only sell such an investment, or force the trust to unwind, for an amount that would be substantially less than the original value of the security. Thus, the fair value of the investment is the amount that would be available to the reporting entity to meet its current and future obligations, and is the amount that should be reflected in the financial statements.

10. SSAP No. 43 impairment guidance does not properly identify these securities as other than temporarily impaired. The use of undiscounted cash flows causes concern among regulators because it ignores the credit dynamic described in paragraphs 6 through 9, and does not provide for proper analysis or valuation of these securities. The fair value of the security in such a situation is what remains of the principal at the measurement date, and it is a substantially diminished value. In order to provide for conservative, consistent and accurate financial statements, an impairment approach that utilizes fair value is necessary to properly analyze and value this class of securities.

11. During discussion of this issue, concerns were raised regarding the impact of the proposed changes to SSAP No. 43 on certain high quality loan-backed securities, such as those issued by the Government National Mortgage Association (GNMA) which are backed by the full faith and credit of the U.S. Government, or those issued by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) which are generally considered to be of extremely high credit quality. The primary concern was that under a fair value impairment approach, these securities would be considered other than temporarily impaired when in an unrealized loss position due to the general fluctuation of market interest rates, though a reporting entity had the intent to hold such a security to maturity.

12. In 2006, the Emerging Accounting Issues Working Group (EAIWG) of the NAIC released INT 06-07: Definition of Phrase “Other Than Temporary” (“INT 06-07”), to address the GAAP guidance issued by the FASB in FSP FAS 115-1/124-1: The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1/124-1). Within INT 06-07, the EAIWG concluded that interest related declines in value should only be considered other than temporary impairments when a reporting entity has the intent to sell the security at the reporting date, before recovery of the cost of the investment. When evaluating for interest related impairment, a reporting entity should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that an investment may need to be sold before the forecasted recovery occurs.

13. Given this interpretation by the EAIWG, and considering that the primary motivation of regulators in proposing revisions to SSAP No. 43 impairment guidance was the proper recognition of credit quality related impairment, the Statutory Accounting Principles Working Group (SAPWG) included language in the exposure draft to specify that interest related declines in value should be considered other than temporary only when the reporting entity has the intent to sell the security, at the reporting date, before recovery of the cost of the investment. This additional guidance is consistent with the statutory accounting interpretation provided in INT 06-07.

14. For clarification purposes, the SAPWG also added language relevant to reporting entities required to maintain an Asset Valuation Reserve (AVR) and an Interest Maintenance Reserve (IMR). The additional guidance specifies that, for companies required to maintain such reserves, credit related other than temporary impairment losses are to be recorded through the AVR, while interest related other than temporary impairment losses are to be recorded through the IMR.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

15. SSAP No. 43, paragraphs 14 through 16:

14. 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 the prospective 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.

15. 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.

16. 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 (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined that a decline in the fair value of a loan-backed security is other than temporary, the cost basis of the 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 Interest Maintenance Reserve (IMR), if applicable). 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.

16. INT 06-07, paragraphs 1 through 8:

1. The Accounting Practices and Procedures Manual contains guidance for determining when an investment is considered impaired within each of the above identified statements. Those statements should also be used to determine the measurement of an impairment loss. Each of the above statements also makes reference to an “other than temporary” decline in fair value. This interpretation is designed to address questions related to that phrase, as well as summarize the statutory accounting process for determining when an investment is considered impaired.

Step 1: Determine Whether an Investment Is Impaired

2. The decision for determining when an investment is considered impaired is dictated by the applicable SSAP and the respective impairment indicators included in each of the SSAPs. If an impairment indicator is present, the determination of an impairment shall be assessed at the individual security or investment level as reported in the annual statement and supporting schedules. For those SSAPs that require the reporting entity to use the fair value to determine if an impairment has occurred, the determination of that value shall be consistent with how the term fair value is defined within the Glossary of the Accounting Practices and Procedures Manual. Once a reporting entity has determined that an impairment indicator is present, the reporting entity shall continue to evaluate whether the investment is impaired each subsequent reporting period until either (a) the investment experiences a recovery of the fair value up to (or beyond) its carrying value or (b) the investor recognizes an other-than-temporary impairment loss.
Step 2: Evaluate Whether an Impairment Is Other Than Temporary

3. There are numerous factors to be considered when determining whether an impairment is other than temporary and their relative significance will vary from case to case. The Emerging Accounting Issues Working Group (working group) has been asked if the phrase “other than temporary” should be interpreted to mean “permanent”. The working group believes the Statutory Accounting Principles Working Group consciously chose the phrase “other than temporary” as the analysis was not intended to determine whether an individual security or investment was “permanently impaired.” The fair value of assets may decline for various reasons. The market price may be affected by general market conditions, which reflect prospects for the economy as a whole, or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment.

4. The working group believes that the following items are only a few examples of the factors, which, individually or in combination, indicate that a security's decline in value is specific to an issuer's fundamental credit difficulties, or that a non-interest related decline is other than temporary and that a write-down of the carrying value is required:

   a. The length of time and the extent to which the fair value has been less than cost;

   b. The financial condition and short-term prospects of the issuer, including any specific events that may influence the operations of the issuer, such as changes in technology, that may impair the earnings potential of the asset or the discontinuance of a segment of the business that may affect the future earnings potential; or

   c. The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in value.

5. An interest related impairment should be deemed other-than-temporary when an investor has the intent to sell an investment, at the reporting date, before recovery of the cost of the investment. The investor should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that the investment may need to be sold before the forecasted recovery occurs. The term “interest related” includes a declining value due to both increases in the risk free interest rate and general credit spread widening. Credit spreads can widen or contract for a variety of reasons, including supply/demand imbalances in the marketplace or perceived higher/lower risk of an entire sector. If the declining value is caused, in whole or in part, due to credit spreads widening, but not due to fundamental credit problems of the issuer, the change in credit spreads is deemed to be interest related. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due.

6. Unless evidence exists to support the assertion that the decline in fair value below carrying value is temporary, a write-down, accounted for as a realized loss, should be recorded. In accordance with the guidance of the SSAPs, such loss should be recognized in income for the period in which other than temporary impairment is determined to have occurred. The adjusted carrying value reflecting the impairment loss of the individual security or investment shall be the new cost basis of the individual security or investment.

7. The working group has also been asked if it is appropriate for reporting entities, independent auditors or state examiners to apply predefined thresholds to the phrase “other than temporary”? The working group is aware that certain insurers, independent auditors and state examiners, over time, have developed quantitative thresholds as “rules of thumb” to assist in the evaluation of asset impairment. One rule of thumb in particular suggests that if the fair value is less than its carrying value by 20 percent or more, then it is considered to be other than temporarily impaired. Another suggests that an asset is other than temporarily impaired if the fair value has been less than cost for more than 6 months. The use of a numerical threshold may
provide the basis for a preliminary assumption that — without considering all relevant circumstances — an impairment may have occurred. Identifying the impairment is only the beginning of the analysis; it cannot appropriately be used as a substitute for a full analysis of all relevant qualitative considerations. Exclusive reliance on such thresholds removes the ability of management to apply its judgment, a concept inherent to the impairment model.

**Step 3: If the Impairment is Other Than Temporary, the Cost Basis of the Individual Asset Shall Be Written Down to a New Cost Basis and the Amount of the Write-Down Is Accounted for as a Realized Loss**

8. If an impairment is considered other than temporary, the cost or carrying value of the asset should be written down to reflect its value in accordance with the relevant SSAP. A company's management should follow the impairment guidance in the SSAP pertaining to that particular asset class while considering various factors on a case-by-case basis in determining the amount of the realized loss that should be recorded.

**Generally Accepted Accounting Principles**
- No additional guidance obtained from GAAP.

**OTHER SOURCES OF INFORMATION**
- No additional guidance obtained from state statutes or regulations.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 43—Loan-Backed and Structured Securities
- SSAP No. 3—Accounting Changes
- SSAP No. 4—Definition of Assets and Nonadmitted Assets
- SSAP No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve
- INT 06-07: Definition of Phrase “Other Than Temporary”

**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

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

**Other Sources of Information**
No additional guidance obtained from other sources of information.
Statutory Issue Paper No. 125

Accounting for Low Income Housing Tax Credit Property Investments

Status:
Finalized December 6, 2004

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. Statement of Statutory Accounting Principles No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48) prescribes accounting treatment for the valuation of Limited Liability Companies. However, current statutory accounting principles do not specifically address accounting for the unique manner in which federal Low Income Housing Tax Credit Property (LIHTC) investments provide a return of investment. Due to the fact that most of these investments are structured as limited partnerships, the majority of these investments fall within the current guidance prescribed by SSAP No. 48. LIHTC investments provide a return on investment in a unique manner, which is not fully recognized under current statutory accounting in SSAP No. 48.


3. The purpose of this issue paper is to provide statutory accounting principles for LIHTC by reconsidering the applicability of EITF 94-1 as appropriate statutory accounting treatment and the development of an accounting model for federal LIHTC investments that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

4. Some states have enacted laws that create programs by which transferable state tax credits are granted to entities under certain specified conditions (e.g., an entity makes an investment in a particular industry). Investments in transferable state tax credits are not within the scope of this issue paper.

RECOMMENDED CONCLUSION

5. This issue paper supersedes paragraph 1 of SSAP No. 48, as follows:

1. This statement establishes statutory accounting principles for investments in joint ventures, partnerships, and limited liability companies. This statement does not address the accounting for investments in partnerships and limited liability companies that invest in federal Low Income Housing Tax Credit Properties as discussed in Issue Paper No. 125—Accounting for Low Income Housing Tax Credit Property Investments.

6. This issue paper modifies Issue Paper No. 99 to remove the reference to EITF 94-1 and in turn, adopts EITF 94-1 with certain modifications.

7. Subject to adoption of a Statement of Statutory Accounting Principles on this topic federal, LIHTC investments held by reporting entities will meet the definition of an asset as specified in SSAP No. 4—Assets and Nonadmitted Assets and are admissible assets to the extent that they comply with the requirements of this issue paper.
The modifications to EITF 94-1 are as follows:

a. LIHTC investments (regardless of whether they are guaranteed) shall be initially recorded at cost and carried at amortized cost unless considered impaired as discussed in paragraphs 13 through 16. The amortized cost method utilized shall be similar to the amortized cost method discussed in EITF 94-1, with a modification to include federal tax benefits during the holding period because the primary value of the LIHTC is derived during the property holding period (typically 15 years). An illustration has been in Appendix A to this statement. A reporting entity investor using the cost method shall amortize any excess of the carrying amount of the investment over its estimated residual value during the periods in which federal tax credits are allocated to the investor. The estimated residual value used in determining the amount to be amortized is the estimated residual value at the end of the last period in which federal tax credits are allocated to the investor and should not reflect anticipated inflation. Annual amortization should be based on the proportion of federal tax credits received in the current year to total estimated federal tax credits to be allocated to the investor.

b. All LIHTC investments in which an investor is a partner or limited partner in affordable housing project for both legal and tax purposes and the investor’s liability is limited to its capital investment shall follow the accounting guidance of this issue paper.

c. Federal tax credits shall be recognized in the income statement as an offset to federal taxes in the tax reporting year in which the tax credit is utilized in accordance with SSAP No. 10—Income Taxes (SSAP No. 10).

d. Tax benefits received, other than tax credits, shall be accounted for pursuant to SSAP No. 10. Amortization shall be reported as a component of net investment income.

e. AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures (SOP 78-9) is rejected for purposes of statutory accounting in SSAP No. 48. This issue paper does not intend to establish SOP 78-9 as applicable to statutory accounting.

f. FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46) is rejected for purposes of statutory accounting in SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3). This issue paper does not intend to establish FIN 46 as applicable to statutory accounting.

g. Many LIHTC investments require future equity contributions by the investor (equity contributions), that may be contingent on a variety of conditions, such as such as receiving representations, contract performance, meeting occupancy requirements, etc. If the commitment by the investor to provide equity contributions meets the definition of a liability as defined in SSAP No. 5—Liabilities Contingencies and Impairments of Assets a liability shall be recorded. If the commitment to provide equity contributions does not meet the definition of a liability, the contingent commitment shall be disclosed in the notes to the financial statements with other contingent commitments.

h. EITF 85-16: Leveraged Leases (EITF 85-16) is adopted for purposes of statutory accounting in SSAP No. 22—Leases (SSAP No. 22). This issue paper does not intend to readdress the conclusions reached in SSAP No. 22.

i. SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities and SSAP No. 88—Investments in Subsidiary, Controlled, and Affiliated Entities, a Replacement of...
SSAP No. 46 should be utilized to account for investments that qualify as subsidiary, controlled or affiliated entities.

j. The impairment guidance contained in this issue paper shall be followed.

k. For statutory accounting purposes, deferred taxes are not reported as a component of income from continuing operations in the income statement; rather, deferred taxes are recognized as a separate component of gains and losses in unassigned funds (surplus).

9. Additional funding that does not result in additional federal tax credits for the investor shall be expensed as a component of net investment income. In the event for a reporting entity obtains additional federal tax credits occurs for a LIHTC investment, the following shall be applied:

a. If additional tax credits are allocated without additional funding, the additional tax credits shall not be afforded any value; rather, the tax benefit is only recognized when realized.

b. If additional funding directly related to the additional tax credits is required, the provisions of this issue paper shall be followed as if the additional funding were a new investment in LIHTC properties.

10. An investment amortized to residual value in accordance with paragraph 8a of this issue paper shall not be revalued under any other method during or subsequent to the amortization period, other than as in this issue paper.

11. Changes in estimated losses shall be accounted for in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors as a change in estimate and included as a component of net investment income.

12. This issue paper shall be interpreted by INT 02-07: Definition of Phrase “Other Than Temporary.” The remaining Interpretations of SSAP No. 48 are deemed not applicable.

Impairment

13. Reporting entities with investments in LIHTC properties shall complete and document an impairment analysis at each reporting period. If it is determined that an impairment exists, the book value of the LIHTC investment shall be compared to the present value of future federal tax benefits discounted at a risk free rate of return, i.e., the rate on U.S. Treasury obligations of a similar duration, and the investment shall be written down if the book value is higher. This will result in 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 value.

14. Among other things, an impairment shall be considered to have occurred if it is probable that future federal tax benefits will not be received as expected. For purposes of determining impairment, future federal tax benefits consist of both estimated tax losses and anticipated tax credits. Loan default or a reasonable probability of credit recapture would signify that tax benefits would not be received as expected.

15. In a multi-tiered partnership, whereby one limited partnership exists only to hold interests in other limited partnerships that are each invested in different developments, the impairment should be determined at the lowest tier. The partnership that holds the assets in which the impairment is determined to exist will be adjusted to a new cost basis representing the lower of book value or the present value of future federal tax benefits discounted at a risk free rate of interest. This new cost basis and related realized loss shall be recognized by the holder of a LIHTC investments.
16. It should be noted that a foreclosure of a single property within an LIHTC investment fund only affects the loss of federal tax credits on a proportional basis. For example, a foreclosure of one property in a six property fund generating equal levels of credits would only eliminate 1/6 of the credits, thereby, only affecting 1/6 of the LIHTC investment fund value to the individual investors.

Audited Financial Statements

17. The reporting entity’s return and book value of an LIHTC investment is reliant upon maintaining federal tax credit eligibility and not its share of the equity as reported on a financial statement. As such, a reporting entity shall monitor the federal tax credit eligibility of an LIHTC investment through requiring either audited GAAP or audited tax basis financial statements. In the event an audited GAAP or audited tax basis financial statement is not obtained, the asset shall be nonadmitted.

Effective Date and Transition

18. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2005. A change resulting from the adoption of the finalized SSAP shall be accounted for as a change in accounting principle in accordance with SSAP No. 3.

DISCUSSION

19. The purpose of this issue paper is to address the unique manner in which LIHTC investments provide a return on investment by reconsidering the applicability of EITF 94-1 as appropriate statutory accounting treatment and the development of an accounting model for LIHTC investments that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy.

20. SSAP No. 48 prescribes accounting treatment for the valuation of limited liability companies. Most of these investments are structured as limited partnerships, and, the majority of these investments fall within the guidance prescribed by SSAP No. 48. LIHTC investments provide a return on investment in a unique manner, which is not fully recognized under current statutory accounting in SSAP No. 48. Currently, such treatment would generally lead to a valuation based on the audited generally accepted accounting principles (GAAP) equity of the limited partnership and; consequently, its underlying real estate investment. However, this treatment does not recognize the value of the federal tax credits (a direct offset to federal income taxes) and the pass through of federal tax losses to the investor. Resale valuation of these investments is based on the present value of the future stream of federal tax credits and deductible losses, and not the market value of the underlying real estate.

21. Current guidance under SSAP No. 48 would require that the equity accounting approach be used to account for investments in LIHTC structured in the form of investments in limited partnerships. One of the implicit assumptions behind the equity methodology is that the operating activities of the entity are reflective of the value being created by the entity. However, this assumption is contrary to how a LIHTC investment provides investment return. The market value of an LIHTC investment is generally unaffected by the operational activities occurring at the operational level of the entity (i.e. generally considered to be the “property” level for investments in more traditional equity real estate deals). Rather, the value of an LIHTC is directly tied to the remaining stream of federal tax benefits (credits and tax losses) available to LIHTC investors. Investments in LIHTC investments, and the related pricing to the investors, are driven primarily by the level of federal tax credits and tax losses that are projected to be produced by the LIHTC during its “credit-producing life.”
22. This critical element of value is typically known with a high degree of certainty before the deal is marketed to potential investors. The degree of certainty regarding projected federal tax credits and tax losses, coupled with market rate returns and below market risk when compared to alternative investments, are what attract investors to an LIHTC investment. Likewise, there is an active secondary market for LIHTC deals. As with primary market transactions, pricing is driven by the remaining federal tax credit and deductible loss streams in the LIHTC investment at resale. Structurally, these investments are typically owned by multiple investors with varying interests in a top tier limited partnership, which in turn holds direct interests in the operating limited partnerships within a single LIHTC investment fund. In other words, a single investor may hold a 15% interest in the “fund” level partnership, which in turns owns 99% interests in 10 operating level limited partnerships. Although, not technically guaranteed as contemplated in EITF 94-1, investment risk in LIHTC’s has proven to be historically low, typically reflecting a default experience similar to that of secured commercial mortgages versus the higher loss rate typically associated with equity real estate investments.

23. The proportional amortized cost method discussed in EITF 94-1 is in line with the Statutory Accounting Concepts of Conservatism and Recognition because the primary value of the LIHTC is derived during the property holding period (typically 15 years). In contrast, GAAP basis financial statements for the limited partnership generally utilize a 40-year depreciation life, which ultimately is picked up by the investor when applying the GAAP equity method.

24. The proportional amortized cost approach results in an investment balance at the end of each accounting period that is more indicative of the liquidation value at that point in time than does the equity method. An impairment analysis should also be made when facts and circumstances indicate an impairment has occurred as well as at the end of each accounting period. If it is probable that the future federal tax benefits will not be received as expected, then an impairment exists, and, the investment should be written down to the lower of fair value or the present value of future federal tax benefits discounted at a risk free rate of return. Since write-down adjustments would be based on actual property level foreclosure or loss of qualification due to occupancy levels or other compliance issues with tax code provisions within an LIHTC fund, subjectivity with respect to the timing and the amount of the write-down would be eliminated. An impairment shall be recorded as a realized loss and the investment written down to the new cost basis.

25. In summary, application of the equity method of accounting for LIHTC investments is inappropriate because the value of the asset is independent from the value of the real estate. Investment balances provided by this methodology are not necessarily reflective of the value that would be received if the assets were to be liquidated. Therefore, the adoption of the proportional cost amortization approach outlined in EITF 94-1 is recommended. This approach leads to a more realistic valuation of the investment and takes into account the fact that the primary value to the investor dissipates to zero when the federal tax credits are no longer available.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
26. SSAP No. 22—Leases provides the following adoption of EITF 85-16 in the relevant literature section of the SSAP.

Relevant Literature
26. This statement 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 in this statement is as follows:
a. FASB Statement No. 13, Accounting for Leases, [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];

aa. FASB Emerging Issues Task Force No. 85-16, Leveraged Leases [adopted in its entirety]

27. SSAP No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies provides the following inclusion of limited liability companies in the scope paragraph.

SCOPE OF STATEMENT
1. This statement establishes statutory accounting principles for investments in joint ventures, partnerships, and limited liability companies.

Generally Accepted Accounting Principles
28. EITF 94-1: Accounting for Tax Benefits from Investments in Affordable Housing Projects provides the following guidance regarding the valuation of

EITF 94-1 ISSUE

The Revenue Reconciliation Act of 1993, enacted in August 1993, retroactively extended and made permanent the affordable housing credit, which had expired after June 30, 1992. Investors in entities operating qualified affordable housing projects receive tax benefits in the form of tax deductions from operating losses and tax credits. The tax credits are allowable on the tax return each year over a 10-year period as a result of renting a sufficient number of units to qualifying tenants and are subject to restrictions on gross rentals paid by those tenants. These credits are subject to recapture over a 15-year period starting with the first year tax credits are earned. Corporate investors generally purchase an interest in a limited partnership that operates the qualified affordable housing projects.

The issue is how an entity that invests in a qualified affordable housing project through a limited partnership should account for its investment.

EITF 94-1 DISCUSSION

The Task Force reached a consensus that immediate recognition at the time the investment is purchased of the entire benefit of the tax credits to be received during the term of a limited partnership investment in a qualified affordable housing project is not appropriate (that is, affordable housing credits should not be recognized in the financial statements prior to their inclusion in the investor's tax return).

The Task Force reached a consensus that an entity that invests in a qualified affordable housing project through a limited partnership investment may elect to account for the investment using the effective yield method (described in the following two paragraphs) provided all of the following conditions are met:

a. The availability (but not necessarily the realization) of the tax credits allocable to the investor is guaranteed by a creditworthy entity through a letter of credit, a tax indemnity agreement, or another similar arrangement.

b. The investor's projected yield based solely on the cash flows from the guaranteed tax credits is positive.

c. The investor is a limited partner in the affordable housing project for both legal and tax purposes and the investor's liability is limited to its capital investment.

Under the effective yield method, the investor recognizes tax credits as they are allocated and amortizes the initial cost of the investment to provide a constant effective yield over the period that tax credits are allocated to the investor. The effective yield is the internal rate of return on the investment, based on the cost of the investment and the guaranteed tax credits allocated to the investor. Any expected residual value of the investment should be excluded from the effective
yield calculation. Cash received from operations of the limited partnership or sale of the property, if any, should be included in earnings when realized or realizable.

Under the effective yield method, the tax credit allocated, net of the amortization of the investment in the limited partnership, is recognized in the income statement as a component of income taxes attributable to continuing operations. Any other tax benefits received should be accounted for pursuant to Statement 109.

For a limited partnership investment in a qualified affordable housing project not accounted for using the effective yield method, the Task Force reached a consensus that the investment should be accounted for in accordance with SOP 78-9. (In accounting for such an investment under SOP 78-9, the consistencies in this Issue that are not related to the effective yield method should be applied.) The Task Force observed that SOP 78-9 generally requires use of the equity method of accounting for limited partnership investments unless the limited partner's interest is so minor as to give the partner virtually no influence over partnership operating and financial policies. [Note: See STATUS section.] The Task Force also noted that the AICPA's Accounting Standards Executive Committee is reconsidering the guidance in SOP 78-9 in its project titled, "Accounting for Investors' Interests in Unconsolidated Real Estate Joint Ventures."

The Task Force also reached a consensus that an investor using the cost method should amortize any excess of the carrying amount of the investment over its estimated residual value during the periods in which tax credits are allocated to the investor. The estimated residual value used in determining the amount to be amortized is the estimated residual value at the end of the last period in which tax credits are allocated to the investor and should not reflect anticipated inflation. Annual amortization should be based on the proportion of tax credits received in the current year to total estimated tax credits to be allocated to the investor.

The Task Force reached a consensus that a limited partnership investment in a qualified affordable housing project should be reviewed periodically for impairment.

The Task Force reached a consensus that a liability should be recognized for delayed equity contributions that are unconditional and legally binding. A liability also should be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable. The Task Force observed that Statement 5, Issue No. 85-16, "Leveraged Leases," and Concepts Statement 6 provide additional guidance on the accounting for delayed equity contributions.

The Task Force observed that the decision to apply the effective yield method of accounting would be an accounting policy decision rather than a decision to be applied to individual investments that qualify for use of the effective yield method. The SEC Observer commented that the SEC staff believes that it would be inappropriate to extend the effective yield method of accounting to analogous situations.

Exhibit 94-1A illustrates the application of the consistencies in this Issue to a limited partnership investment in an affordable housing project accounted for using the cost, equity, and effective yield methods.

EITF 94-1 STATUS

The SEC Observer at the May 18-19, 1995 meeting discussed a related issue in an announcement. The announcement addresses the SEC staff's position concerning the application of the equity method to investments in limited partnerships. [Note: See Topic No. D-46 in Appendix D.]

Interpretation 46, which was issued in January 2003, addresses consolidation by business enterprises of variable interest entities, which may include some limited partnerships. Interpretation 46 requires a variable interest entity to be consolidated by an enterprise if that enterprise will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both. The consolidation requirements of Interpretation
46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established.

FSP FIN 46-6 deferred the effective date for applying the provisions of Interpretation 46 for:
1. Interests held by a public entity in variable interest entities created before February 1, 2003, if the public entity has not issued financial statements reporting that interest in accordance with Interpretation 46. The application of Interpretation 46 to those interests is deferred until the end of the first period ending after December 15, 2003.
2. Nonregistered investment companies accounting for their investments in accordance with the specialized accounting guidance in the investment company Guide.

No further EITF discussion is planned.

See Appendix A to this issue paper for illustration of the amortized cost method (modified to include tax benefits).

EITF 85-16: Leveraged Leases

EITF 85-16 (B) DISCUSSION
The Task Force reached a consensus that the type of recourse debt resulting from the delayed equity investment does not contradict the notion of nonrecourse under paragraph 42(c) of Statement 13 and, therefore, does not preclude leveraged lease accounting as long as other requirements of leveraged lease accounting are met. The Task Force also agreed that the lessor's related obligation should be recorded as a liability at present value at the inception of the lease. The Task Force agreed that recognition of the liability would increase the lessor's net investment on which the lessor bases its pattern of income recognition. It was noted that while the increase to the net investment results in an increase in income, it tends to be offset by the accrual of interest on the liability.

RELEVANT LITERATURE

Statutory Accounting
- SSAP No. 3—Accounting Changes and Corrections of Errors
- SSAP No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies

Generally Accepted Accounting Principles
- EITF 94-1: Accounting for Tax Benefits from Investments in Affordable Housing Projects
- AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures
- FASB Interpretation No. 46, Consolidation of Variable Interest Entities
- EITF 85-16: Leveraged Leases

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

Other Sources:
- Internal Revenue Code Section 42-Low-Income Housing Credit
Appendix A – Low Income Housing Tax Credit Property Investments
A Limited Partnership Investment in an Affordable Housing Project Accounted for Using the Amortized Cost Method (modified to include tax benefits):

This appendix is based on EITF 94-1 “Schedule 3 Cost Method with Amortization with modifications to include tax benefits.

Terms:
Date of Investment: January 1, 20X1
Purchase Price of Investment: $100,000

Assumptions:
1. All cash flows (except initial investment) occur at the end of each year.
2. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).
3. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.
4. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.
5. The annual tax credit allocation (equal to 8 percent of the project's original cost) will be received for a period of 10 years.
6. The investor's tax rate is 35 percent.
7. For simplicity, the project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.
8. The project's taxable and book loss will be equal to depreciation expense.
9. The investor will maintain the investment for 15 years (so there will be no recapture of tax credits).
10. The investor expects that the estimated residual value of the investment will be zero.
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1. Beginning-of-year investment for a 5 percent limited partnership interest in the project.
2. 8 percent tax credit on $200,000 tax basis of the underlying assets.
3. Tax Loss = Tax Depreciation (assumption 7) - $200,000 tax basis of the underlying assets using the straight-line method over 27.5 years.
4. Column (3) × 35% tax rate.
5. Column (2) + column (4)
6. Proportional amortization - $100,000 x column 5 / column 5 total
7. Beginning-of-year investment for a 5 percent limited partnership interest in the project (column 1) net of amortization in column 6.
Statutory Issue Paper No. 126

Accounting for Transferable State Tax Credits

STATUS:
Finalized December 5, 2005

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish statutory accounting principles for transferable state tax credits that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Currently, generally accepted accounting principles do not provide separate guidance for transferable state tax credits; general guidance for income taxes is found in FASB Statement No. 109, Accounting for Income Taxes (FAS 109). SSAP No. 10—Income Taxes (SSAP No. 10), paragraph 2 notes the adoption of FAS 109 with modifications for state income taxes, the realization criteria for deferred tax assets, and the recording of the impact of changes in its deferred tax balances.

3. Investments in Low Income Housing Tax Credits as discussed in SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments, which involve an investment by a reporting entity in a limited liability company or similar entity that earns tax credits as a consequence of its operating activities involving low income housing developments and passes those tax credits to its investors, are not within the scope of this issue paper.

SUMMARY CONCLUSION

Definitions

4. Some states have enacted laws that create programs by which transferable state tax credits are granted to entities under certain specified conditions (e.g., an entity makes an investment in a particular industry). The terms of these state tax credits vary from state to state and, within a state, from program to program. However, many of these state tax credit programs share the following four characteristics:

   a. The tax credit is nonrefundable;

   b. The holder of the transferable state tax credit may sell or otherwise transfer the transferable state tax credit to another entity, which can likewise resell or transfer the credit;

   c. The transferable state tax credit will expire if not used by a predetermined date; and

   d. The transferable state tax credit can be applied against either state income tax or state premium tax.

5. For purposes of this issue paper, such programs will be referred to as “transferable state tax credits.” The criteria in subparagraphs 4.b., 4.c. and 4.d. must be present in order for the transferable state tax credit to receive the accounting treatment described in this issue paper. When a reporting entity purchases a transferable state tax credit from another entity, the transaction does not result in a continuing investment in a business entity (i.e. limited partnership).
6. Subject to adoption of a Statement of Statutory Accounting Principles (SSAP) on this topic, transferable state tax credits held by reporting entities will meet the definition of assets as specified in SSAP No. 4—Assets and Nonadmitted Assets and will be admissible assets to the extent that they comply with the requirements of the SSAP.

**Acquisition**

7. Transferable state tax credits are recorded at cost at the date of acquisition.

**Balance Sheet Treatment**

8. Transferable state tax credits expected to be realized are initially recorded at cost.

9. Transferable state tax credits shall be established gross of any related state tax liabilities and reported in the category of other than invested assets (not reported net).

10. As transferable state tax credits are redeemed, the carrying value of the tax credits is reduced dollar for dollar by the amount of transferable state tax credits applied toward the reporting entity’s applicable state tax liability.

**Income Statement Treatment**

11. Gains on transferable state tax credits are deferred until the value of the transferable state tax credits utilized exceeds the cost of the transferable state tax credits or until the transferable state tax credits are sold to other entities and the payment received is greater than the book value.

12. Losses on transferable state tax credits are recognized when known.

13. Gains and losses on transferable state tax credits are reflected in other income.

**Impairment**

14. 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 transferable state tax credits. Transferable state tax credits should be evaluated for impairment at each reporting date.

15. When there is a decline in the realizability of a transferable state tax credit owned by the reporting entity that is other than temporary, the asset shall be written down to the expected realizable amount and the amount of the write down shall be accounted for as a realized loss. The expected realizable value is the new cost basis.

16. The new cost basis shall not be changed for subsequent recoveries in realizability.

**Disclosures**

17. The following disclosures shall be made in the financial statements. For purposes of this disclosure, total unused transferable state tax credits represent the entire transferable state tax credits available:

   a. Carrying value of transferable state tax credits gross of any related state tax liabilities by state and in total,

   b. Total unused transferable state tax credits by state;
c. Method of estimating utilization of remaining transferable state tax credits or other projected recovery of the current carrying value.

d. Impairment amount recognized in the reporting period, if any.

Effective Date and Transition

18. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2006.

DISCUSSION

19. This issue paper provides new statutory accounting guidance for a type of investment, which is not currently addressed in the Accounting Practices and Procedures Manual. Therefore, in accordance with SSAP No. 4, they default to a nonadmitted asset. In evaluating transferable state tax credits, several points were considered. The transferable characteristics of these state tax credit are a major factor in developing statutory accounting guidance, which would admit investments in transferable state tax credits that comply with the guidance.

20. It is consistent with the Statement of Concepts, conservatism to report the transferable state tax credits at cost.

21. Reporting the transferable state tax credits gross is consistent with other reporting and with the principles in SSAP No. 64—Offsetting and Netting of Assets and Liabilities. State premium tax liabilities for multiple states are reported on the same annual statement line on the liabilities page of the annual statement. Therefore, if a reporting entity wrote business in multiple states, it would violate the SSAP No. 64—Offsetting and Netting of Assets and Liabilities offsetting criteria to net the premium tax liability from one state against a premium tax credit of another state.

22. The primary reason for purchasing transferable state tax credits is to reduce state premium tax expenses. They are not purchased for investment income, so it seems appropriate to report transferable state tax credits as other than invested assets. Losses are realized losses in the other income category.

23. It is consistent with the concept of conservatism to delay any recognition of gain on the utilization or sales of transferable state tax credits until the gain is realized. Realization is determined to have occurred when the state tax credits are utilized and meet or exceed the cost of the credits, or credits are sold and the sales price realized meets or exceeds the cost of state tax credits sold.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

24. SSAP No. 10—Income Taxes provides the following references on state income taxes:

2. For purposes of accounting for federal and foreign income taxes, reporting entities shall adopt FASB Statement No. 109, Accounting for Income Taxes (FAS 109) with modifications for state income taxes, the realization criteria for deferred tax assets, and the recording of the impact of changes in its deferred tax balances. As a result, financial statements will recognize current and deferred income tax assets and liabilities in accordance with the provisions of this statement.
4. State taxes (including premium, income and franchise taxes) shall be computed in accordance with SSAP No. 5 and shall be limited to (a) taxes due as a result of the current year's taxable basis calculated in accordance with state laws and regulations and (b) amounts incurred or received during the current year relating to prior periods, to the extent not previously provided as such amounts are deemed to be changes in accounting estimates. Property and casualty insurance companies shall report state taxes as other underwriting expenses under the caption "Taxes, licenses, and fees." Life and accident and health insurance companies shall report such amounts as general expenses under the caption "Insurance taxes, licenses, and fees," excluding federal income taxes. Other health entities shall report such amounts as general administration expenses under the caption "Taxes, licenses, and fees." State tax recoverables that are reasonably expected to be recovered in a subsequent accounting period are admitted assets. State taxes are reasonably expected to be recovered if the refund is attributable to overpayment of estimated tax payments, errors, carrybacks, or items for which the reporting entity has authority to recover under a state regulation or statute.

1.1 A – SSAP No. 10 establishes statutory accounting principles for current and deferred federal and foreign income taxes and current state income taxes. In general, SSAP No. 10 adopts the concepts of FAS 109, with modifications. The primary differences and modifications are summarized below:

1.2 State Income Tax

- FAS 109 – State income taxes should be included as "income taxes incurred." Deferred state income taxes are provided.

- SSAP No. 10 – State income taxes should be included as "Taxes, Licenses, and Fees" by property and casualty insurers and as "Insurance taxes, licenses, and fees, excluding federal income taxes" by life and accident and health insurers. No deferred state income taxes are provided.

25. Statutory accounting guidance does not currently address transferable state tax credits, therefore, in accordance with SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4), transferable state tax credits default to nonadmitted assets at this time.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 10—Income Taxes

Generally Accepted Accounting Principles

- FASB Statement No. 109, Accounting for Income Taxes was adopted with modification in SSAP No. 10—Income Taxes

State Regulations

- No additional guidance obtained from state statutes or regulations
Implementation Guide

On 1/1/X1 SAM Insurance Company purchased transferable state tax credits for a cost of $100,000. The transferable state tax credits are redeemable for $160,000 and expire at the end of 12/31/X4. SAM initially expects to utilize the tax credits before expiration in their state of domicile in the amount of $40,000 per year. In year X4, SAM sells the remaining $30,000 in transferable state tax credits for $20,000.

1/1/x1 Transferable state tax credits 100,000
Cash 100,000
To record the purchase of the tax credits

6/30/x1 Premium tax expense 40,000
Premium taxes payable to domiciliary state 40,000
To record premium tax expense and accrue the liability in Year 1.

10/1/x1 Premium tax payable 40,000
Transferable state tax credits 40,000
To record the use of tax credits in Year 1. The reporting entity expects to be able to utilize remaining tax credits before expiration.

6/30/x2 Premium tax expense 60,000
Premium taxes payable to domiciliary state 60,000
To record premium tax expense and accrue the liability in Year 2.

9/30/x2 Premium tax payable 60,000
Transferable state tax credits 60,000
To record the use of tax credits in Year 2. The reporting entity expects to be able to utilize remaining tax credits before expiration.

6/30/x3 Premium tax expense 30,000
Premium taxes payable to domiciliary state 30,000
To record premium tax expense and accrue the liability in Year 3.

9/30/x3 Premium tax payable 30,000
Other income 30,000
To record the use of premium tax credits in excess of cost and recognize a gain on premium tax credits in other income. The Company intends to sell the remaining tax credits in year 4.

6/30/x4 Cash 20,000
Other income 20,000
To record the sale of the remaining tax credits.
Statutory Issue Paper No. 127

Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions

STATUS:
Finalized March 6, 2006

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Existing statutory accounting literature for nonmonetary transactions is maintained within SSAP No. 28—Nonmonetary Transactions (SSAP No. 28), which is based on Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions (APB 29). APB 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. However, this guidance includes an exception to this basic premise for nonmonetary exchanges of similar productive assets. Statement of Financial Accounting Standards No. 153: Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29 (FAS 153), eliminates this exception and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the reporting entity are expected to change significantly as a result of the exchange.

2. The concept of similar productive assets is brought into statutory accounting by the adoption of APB 29 in SSAP No. 28. The concept of commercial substance introduced in FAS 153 is not explicitly discussed in statutory accounting.

   FAS 153 affects the following:
   
   • APB Opinion No. 29, Accounting for Nonmonetary Transactions (APB 29) which is adopted in SSAP No. 28—Nonmonetary Transactions
   • Amends FAS 19, Financial Accounting and Reporting by Oil and Gas Producing Companies, which is not applicable to statutory accounting
   • Amends FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, A Replacement of FASB Statement 125, which is adopted with modification in SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91)
   • Amends FAS 144, which is adopted with modification in SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments (SSAP No. 90)

3. Statutory accounting principles currently exist for nonmonetary exchanges in SSAP No. 28—Nonmonetary Transactions (SSAP No. 28). Some elements of APB 29 were adopted and modified for statutory accounting and reporting directly within SSAP No. 28. Other requirements of APB 29 were adopted through reference as in paragraph 3 of SSAP No. 28:

   3. Except as addressed in other statements (including, but not limited to, SSAP No. 12—Employee Stock Ownership Plans (SSAP No. 12), SSAP No. 13—Stock Option and Stock Purchase Plans (SSAP No. 13), SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25), SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68), and SSAP No. 72—Surplus and Quasi-reorganizations (SSAP No. 72)), nonmonetary transactions shall be accounted for in accordance with Accounting...
Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions (APB 29). The accounting for such transactions shall be based on the fair values of the assets (or services) involved, as defined in paragraph 25 of APB 29.

4. The purpose of this issue paper is to update statutory accounting principles for nonmonetary transactions by updating conclusions reached in SSAP No. 28 related to APB 29 with those included in FAS 153. Consequently, this issue paper adopts FAS 153 with modifications to change GAAP references to those applicable to statutory accounting. In addition, references made to APB 29 within SSAP No. 28 will be replaced with the actual amended guidance resulting from FAS 153.

5. In addition, the purpose of this issue paper is to also amend language used in SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments, Discontinued Operations (SSAP No. 90) affected by FAS 153.

SUMMARY CONCLUSION

Definitions

6. The definitions of certain terms used in this statement are:

   a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash; amounts due from agents, brokers, and intermediaries; policy loans; accounts payable; and other amounts receivable or payable in cash;

   b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are common stocks; furniture, fixtures, and equipment; real estate and liabilities for rent collected in advance;

   c. Exchange (or exchange transaction) is a reciprocal transfer between a reporting entity and another entity that results in the reporting entity acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. A reciprocal transfer of a nonmonetary asset shall be deemed an exchange only if the transferor has no substantial continuing involvement in the transferred asset such that the usual risks and rewards of ownership of the asset are transferred.

   d. Nonreciprocal transfer is a transfer of assets or services in one direction, either from a reporting entity to its owners (whether or not in exchange for their ownership interests) or another entity, or from owners or another entity, to the reporting entity. An insurance company's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

7. Nonmonetary transactions shall be accounted for in accordance with this statement, except as addressed by other statements or interpretations including but not limited to SSAP No. 12—Employee Stock Ownership Plans (SSAP No. 12), SSAP No. 13—Stock Option and Stock Purchase Plans (SSAP No. 13), SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25), SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68), SSAP No. 72—Surplus and Quasi-reorganizations (SSAP No. 72), SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91), INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments, INT 00-12: EITF 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company, INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or a Business (INT 00-26), INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions (INT 00-29), and INT 03-16: Contribution of Stock (INT 03-16).
8. Accounting for nonmonetary transactions shall generally be based on the fair values of the assets (or services) involved, as defined in paragraph 16, which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset (reciprocal transactions) is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received as defined in paragraph 9. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of a reporting entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).

9. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities, SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities), SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities), SSAP No. 37—Mortgage Loans, SSAP No. 39—Reverse Mortgages, SSAP No. 40—Real Estate Investments, SSAP No. 43—Loan-backed and Structured Securities or other applicable statement. The guidance provided in SSAP No. 25 shall be followed in accounting for nonreciprocal transactions with affiliates and other related parties as defined in that statement.

10. A nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset(s) relinquished (SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments, Discontinued Operations, (paragraph 20)), and not on the fair values of the exchanged assets, if any of the following conditions apply:

   a. **Fair Value Not Determinable.** The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits (paragraph 16).

   b. **Exchange Transaction to Facilitate Sales to Customers.** The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.

   c. **Exchange Transaction That Lacks Commercial Substance.** The transaction lacks commercial substance (paragraph 11).

11. A nonmonetary exchange has commercial substance if the entity's future cash flows are expected to significantly change as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria is met:

   a. The configuration (risk, timing, and amount)\(^1\) of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.

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\(^1\) The configuration of future cash flows is composed of the risk, timing, and amount of the cash flows. A change in any one of those elements would be a change in configuration.
b. The entity-specific value\(^2\) of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.

A qualitative assessment will, in some cases, be conclusive in determining that the estimated cash flows of the entity are expected to significantly change as a result of the exchange.

12. In the United States and some other tax jurisdictions, a transaction is not given effect for tax purposes unless it serves a legitimate business purpose other than tax avoidance. In assessing the commercial substance of an exchange, tax cash flows that arise solely because the tax business purpose is based on achieving a specified financial reporting result shall not be considered.

13. Stock received in the form of a stock dividend or stock split shall not result in the recognition of income. The cost basis of stock held shall be reallocated ratably to the total shares held after receipt of the stock dividend or stock split.

14. The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraphs 10 & 11) may include an amount of monetary consideration. The recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. However, the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraphs 10 & 11 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraphs 10 & 11, the entire indicated loss on the exchange should be recognized.

15. **Nonreciprocal Transfers to Owners.** Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) (An indicated impairment of value of a long-lived asset covered by SSAP No. 90 shall be determined in accordance with paragraph 20 of that Statement) of the nonmonetary assets distributed. A prorata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

16. Fair value of a nonmonetary asset transferred to or from a reporting entity in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

\(^2\) An entity-specific value (referred to as an entity-specific measurement in Concepts Statement 7) is different from a fair value measurement. As described in paragraph 24(b) of Concepts Statement 7, an entity-specific value attempts to capture the value of an asset or liability in the context of a particular entity. For example, an entity computing an entity-specific value of an asset would use its expectations about its use of that asset rather than the use assumed by marketplace participants. If it is determined that the transaction has commercial substance, the exchange would be measured at fair value, rather than at the entity-specific value.
17. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value. An exchange involving parties with essentially opposing interests is not considered a prerequisite to determining a fair value of a nonmonetary asset transferred; nor does an exchange insure that a fair value for accounting purposes can be ascertained within reasonable limits. If neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the enterprise may be the only available measure of the transaction.

18. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for according to SSAP No. 10—Income Taxes.

19. Involuntary conversions of nonmonetary assets to monetary assets (for example, as a result of total or partial destruction, theft, seizure, or condemnation) are monetary transactions for which gain or loss shall be recognized even though a reporting entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with the conclusions in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5). Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be reported consistently with the reporting entity's reporting of continuing operations and disclosed in the notes to financial statements in accordance with SSAP No. 24—Discontinued Operations and Extraordinary Items (SSAP No. 24).

20. Language used in the accounting guidance for long-lived assets to be disposed of other than by sale in paragraphs 18 through 20 of SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments, Discontinued Operations (SSAP No. 90), including section titles, shall be amended as follows:

**Long-Lived Assets to Be Disposed Of Other Than By Sale**

18. A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange measured based on the recorded amount of the nonmonetary asset relinquished for a similar productive long-lived asset, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until disposal. Paragraphs 4 through 17, and 31 through 35 shall apply while the asset is classified as held and used. If a long-lived asset is to be abandoned or distributed to owners in a spinoff together with other assets (and liabilities) as a group and that disposal group is a segment, paragraphs 31 through 35 shall apply to the disposal group at the date of disposal.

**Long-Lived Asset to Be Abandoned**

19. For purposes of this statement, a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with SSAP No. 3 to reflect the use of the asset over its shortened useful life. A long-lived asset that has been temporarily idled shall not be accounted for as if abandoned.

**Long-Lived Asset to Be Exchanged for a Similarly Productive Long-Lived Asset or to Be Distributed to Owners in a Spinoff**

20. For purposes of this statement, a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished...
exchanged for a similarly productive long-lived asset or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset exceeds its fair value.\(^3\)

Disclosures

21. A reporting entity that engages in a nonmonetary transaction during a period shall disclose the following in the financial statements:

   a. The nature of the transaction;

   b. The basis of accounting for the assets transferred; and

   c. Gains or losses recognized on transfers.

22. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure in paragraph 21 above shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

23. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2006.

DISCUSSION

24. In December 2004, the FASB issued SFAS No. 153: Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29 (APB 29) to improve the comparability of cross-boarder financial reporting. Working with the International Accounting Standards Board (IASB), FAS 153 was issued as part of a joint effort between the FASB and the IASB to develop a single set of high-quality accounting standards by eliminating a narrow difference between existing accounting standards relative to nonmonetary exchanges.

25. Although not meant to be all inclusive, accounting for specific nonmonetary transactions and unique circumstances is addressed in the following statements of statutory accounting principles:

   - **SSAP No. 12—Employee Stock Ownership Plans** (SSAP No. 12),
   - **SSAP No. 13—Stock Options and Stock Purchase Plans** (SSAP No. 13),
   - **SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties** (SSAP No. 25),
   - **SSAP No. 68—Business Combinations and Goodwill** (SSAP No. 68),

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\(^3\) The provisions of this paragraph apply to nonmonetary exchanges that are not recorded at fair value under the provisions of paragraphs 10 and 15 of this issue paper.
Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions

IP No. 127

- SSAP No. 72—Surplus and Quasi-reorganizations (SSAP No. 72),
- SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91),
- INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments,
- INT 00-12: EITF 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company,
- INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or of a Business (INT 00-26),
- INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions (INT 00-29), and
- INT 03-16: Contribution of Stock (INT 03-16).

26. This issue paper updates general statutory guidance for accounting for nonmonetary transactions not specifically addressed in the statements of statutory accounting principles noted above and carries forward current statutory guidance for stock dividends and stock splits received, other types of nonmonetary transactions and involuntary conversions of nonmonetary assets to monetary assets. The guidance in this issue paper remains consistent with the guidance provided in SSAP No. 30—Investments in Common Stock (excluding investment in common stock of subsidiary, controlled, or affiliated entities) (SSAP No. 30), which addresses cash dividends and requires that dividends on common stock be recorded as investment income when declared with a corresponding receivable to be extinguished upon receipt of cash. This issue paper carries forward the disclosure requirements related to nonmonetary transactions from SSAP No. 28.

27. This issue paper adopts APB 29 as modified by FAS 153.

28. This issue paper adopts FAS 153 with modifications for references to statements of statutory accounting principles.

29. This issue paper continues the adoption of ARB 43, Chapter 7, Section B paragraphs 1 through 9 as such relates to the receipt of stock in the form of a stock in the form of a stock dividend or stock split. This conclusion is consistent with the recognition concept included in the Statement of Concepts, which states, “Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed”.

30. This issue paper continues the adoption of FIN 30 with modification to provide that gain or loss contingencies be recognized in accordance with the conclusion in SSAP No. 5 and that gain or loss resulting from an involuntary conversion of nonmonetary assets to monetary assets be accounted for in continuing operations and disclosed in accordance with SSAP No. 24—Discontinued Operations and Extraordinary Items.

31. This issue paper continues the adoption of EITF 86-29 and EITF 93-11 consistent with the general rule discussed in paragraph 26 above.

32. This issue paper continues the rejection of paragraph 16 of Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins and Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners.
33. The conclusions above are consistent with the recognition concept included in the Statement of Concepts. The recognition concept states:

The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

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

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

Drafting Notes/Comments

34. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

35. Statutory accounting principles currently exist for nonmonetary exchanges in SSAP No. 28—Nonmonetary Transactions (SSAP No. 28). Statutory accounting guidance regarding nonmonetary transactions related to assets transferred between affiliates currently exists in SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and other Related Parties (SSAP No. 25).

Generally Accepted Accounting Principles

36. APB 29, as amended by FAS 153, provides the following guidance:

INTRODUCTION

1. Most business transactions involve exchanges of cash or other monetary assets or liabilities1 for goods or services. The amount of monetary assets or liabilities exchanged generally provides an objective basis for measuring the cost of nonmonetary assets or services received by an enterprise as well as for measuring gain or loss on nonmonetary assets transferred from an enterprise. Some transactions, however, involve either (a) an exchange with another entity (reciprocal transfer1) that involves principally nonmonetary assets or liabilities1 or (b) a transfer of nonmonetary assets for which no assets are received or relinquished in exchange (nonreciprocal transfer1). Both exchanges and nonreciprocal transfers that involve little or no monetary assets or liabilities are referred to in this section as nonmonetary transactions.
2. Questions have been raised concerning the determination of the amount to assign to a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction and also concerning the recognition of a gain or loss on a nonmonetary asset transferred from an enterprise in a nonmonetary transaction. Practice has varied; some nonmonetary transactions have been accounted for at the estimated fair value of the assets transferred and some at the amounts at which the assets transferred were previously recorded. This Opinion sets forth the views of the Board on accounting for nonmonetary transactions.

Definitions

3. The meanings of certain terms used in this section are:

a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short or long-term accounts and notes receivable in cash, and short- or long-term accounts and notes payable in cash.2

b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are inventories; investments in common stocks; property, plant and equipment; and liabilities for rent collected in advance. 2

2 APB Statement No. 3, Financial Statements Restated for General Price-Level Changes, paragraphs 17-19, and Appendix B, contains a more complete explanation of monetary and nonmonetary items.

c. Exchange (or exchange transaction) is a reciprocal transfer between an enterprise and another entity that results in the enterprise's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. A reciprocal transfer of a nonmonetary asset shall be deemed an exchange only if the transferor has no substantial continuing involvement in the transferred asset such that the usual risks and rewards of ownership of the asset are transferred.

d. Nonreciprocal transfer is a transfer of assets or services in one direction, either from an enterprise to its owners (whether or not in exchange for their ownership interests) or another entity or from owners or another entity to the enterprise. An entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

e. Productive assets are assets held for or used in the production of goods or services by the enterprise. Productive assets include an investment in another entity if the investment is accounted for by the equity method but exclude an investment not accounted for by that method. Similar productive assets are productive assets that are of the same general type, that perform the same function or that are employed in the same line of business.
Applicability

4. This Opinion does not apply to the following transactions:

a. A business combination accounted for by an enterprise according to the provisions of FASB Statement No. 141, Business Combinations, 3a

3a Paragraph 10 of Statement 141 states that an exchange of a business for a business is a business combination.

b. A transfer of nonmonetary assets solely between companies or persons under common control, such as between a parent company and its subsidiaries or between two subsidiary corporations of the same parent, or between a corporate joint venture and its owners,

c. Acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise, 4

4 FASB Statement No. 123 (revised 2004), Share-Based Payment, applies to all transactions in which an entity acquires goods or services by issuing its shares or other equity instruments (except for equity instruments held by an employee stock ownership plan or by incurring liabilities to the supplier (a) in amounts based, at least in part, on the price of the entity's shares or other equity instruments or (b) that require or may require settlement by issuance of the entity's shares or other equity instruments.

d. Stock issued or received in stock dividends and stock splits which are accounted for in accordance with ARB No. 43, Chapter 7B,

e. A transfer of assets to an entity in exchange for an equity interest in that entity,

f. A pooling of assets in a joint undertaking intended to find, develop, or produce oil or gas from a particular property or group of properties, as described in paragraph 44 of FASB Statement No. 19, Financial Accounting and Reporting by Oil and Gas Producing Companies, as amended by FASB Statements No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, No. 145, Recission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections, and No. 153, Exchanges of Nonmonetary Assets,

g. The exchange of a part of an operating interest owned for a part of an operating interest owned by another party that is subject to paragraph 47(e) of Statement 19, and

h. The transfer of a financial asset within the scope of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

Some exchanges of nonmonetary assets involve a small monetary consideration, referred to as "boot," even though the exchange is essentially nonmonetary. This Opinion also applies to those transactions. For purposes of applying this Opinion, events and transactions in which
nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets—are monetary transactions since the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets.

DISCUSSION

Present Accounting for Nonmonetary Transactions

5. **Nonreciprocal Transfers with Owners.** Some nonmonetary transactions are nonreciprocal transfers between an enterprise and its owners. Examples include (a) distribution of nonmonetary assets, such as marketable equity securities, to stockholders as dividends, (b) distribution of nonmonetary assets, such as marketable equity securities, to stockholders to redeem or acquire outstanding capital stock of the enterprise, (c) distribution of nonmonetary assets, such as capital stock of subsidiaries, to stockholders in corporate liquidations or plans of reorganization that involve disposing of all or a significant segment of the business (the plans are variously referred to as spin-offs, split-ups, and split-offs), and (d) distribution of nonmonetary assets to groups of stockholders, pursuant to plans of rescission or other settlements relating to a prior business combination, to redeem or acquire shares of capital stock previously issued in a business combination. Accounting for decreases in owners’ equity that result from nonreciprocal nonmonetary transactions with owners has usually been based on the recorded amount of the nonmonetary assets distributed.

6. **Nonreciprocal Transfers with Other Than Owners.** Other nonmonetary transactions are nonreciprocal transfers between an enterprise and entities other than its owners. Examples are the contribution of nonmonetary assets by an enterprise to a charitable organization and the contribution of land by a governmental unit for construction of productive facilities by an enterprise. Accounting for nonmonetary assets received in a nonreciprocal transfer from an entity other than an owner has usually been based on fair value of the assets received while accounting for nonmonetary assets transferred to another entity has usually been based on the recorded amount of the assets relinquished.

7. **Nonmonetary Exchanges.** Many nonmonetary transactions are exchanges of nonmonetary assets or services with another entity. Examples include (a) exchange of product held for sale in the ordinary course of business (inventory) for dissimilar property as a means of selling the product to a customer, (b) exchange of product held for sale in the ordinary course of business (inventory) for similar product as an accommodation—that is, at least one party to the exchange reduces transportation costs, meets immediate inventory needs, or otherwise reduces costs or facilitates ultimate sale of the product—and not as a means of selling the product to a customer, and (c) exchange of productive assets—assets employed in production rather than held for sale in the ordinary course of business—between similar productive assets or for an equivalent interest in similar productive assets. Examples of exchanges in category (c) include the trade of player contracts by professional sports organizations, exchange of leases on mineral properties, exchange of one form of interest in an oil producing property for another form of interest, exchange of real estate for real estate. Accounting for nonmonetary assets acquired in a nonmonetary exchange has sometimes been based on the fair value of the assets relinquished and sometimes on the recorded amount of the assets relinquished.

Differing Views

8. Views of accountants differ as to appropriate accounting for all of the types of nonmonetary transactions described in paragraphs 5 to 7.

9. **Nonreciprocal Transfers of Nonmonetary Assets to Owners.** Some believe that accounting for nonreciprocal transfers of nonmonetary assets to owners should be based
on the carrying amount of the nonmonetary assets transferred because only that method is consistent with the historical cost basis of accounting.

10. Others believe that accounting for transfers of nonmonetary assets to reduce certain owners' interests other than through a reorganization, liquidation, or rescission of a prior business combination should be based on the fair value of the nonmonetary assets distributed or the fair value of the stock representing the owners' equity eliminated, whichever is more clearly evident. In their view, disposing of the value represented by a nonmonetary asset is a significant economic event, and the unrecorded increase or decrease that has resulted in the value of the nonmonetary asset since its acquisition should be recognized.

11. Many who agree with accounting based on fair value for a nonreciprocal transfer of a nonmonetary asset that reduces certain owners' interests also believe that distributing a nonmonetary asset as an ordinary dividend (but not distributing a nonmonetary asset as a liquidating dividend or in a spin-off, reorganization or similar distributions) may be regarded as equivalent to an exchange with owners and therefore recorded at the fair value of the nonmonetary asset distributed, particularly if the dividend is distributable as either cash or the nonmonetary asset at the election of the owner. They believe that failure to recognize the fair value of nonmonetary assets transferred may both misstate the dividend and fail to recognize gains and losses on nonmonetary assets that have already been earned or incurred by the enterprise and should be recognized on distributing the assets for dividend purposes.

12. Others generally agree with the view that nonreciprocal transfers of nonmonetary assets to certain owners should be accounted for at fair value but believe that dividends and other prorata distributions to owners are essentially similar to liquidating dividends or distributions in spin-offs and reorganizations and should be accounted for at the recorded amount of the asset transferred.

13. Nonreciprocal Receipts of Nonmonetary Assets. Many believe that a nonmonetary asset received in a nonreciprocal transfer from other than owners should be recorded at fair value because fair value is the only value relevant to the recipient enterprise. Others believe that such nonmonetary assets should be recorded at a nominal value since fair value cannot be reasonably determined in view of performance obligations usually agreed to by the recipient as a consideration for the transfer.

14. Nonreciprocal Transfers of Nonmonetary Assets to Other Than Owners. Some believe that accounting for a nonreciprocal transfer of a nonmonetary asset to an entity other than an owner should be based on the carrying amount of the asset transferred because only that method is consistent with the historical cost basis of accounting. Others believe that failure to recognize the fair value of a nonmonetary asset transferred may both underestimate (or overstate) expenses incurred and fail to recognize gains or losses on nonmonetary assets that have already been earned or incurred by the enterprise and should be recognized when the transfer of the asset is recognized as an expense.

15. Exchange Transactions. Some believe that accounting for an exchange of nonmonetary assets between an enterprise and another entity (an enterprise or individual acting in a capacity other than a stockholder of the enterprise) should be based on the fair values of the assets involved, while others believe that accounting for the exchange should be based on the carrying amount of the asset transferred from the enterprise. Those who advocate the former view believe it to be the only method consistent with the accounting principle that an asset acquired should be recorded at its cost as measured by the fair value of the asset relinquished to acquire it. Those advocating the latter view believe that revenue should be recognized only if an exchange involves monetary assets; therefore recognizing fair value is inappropriate unless a monetary asset is received in an exchange.
Many accountants who accept the concept that accounting for an exchange of nonmonetary assets should be based on fair value believe that problems of measurement and questions about the conditions for recognizing revenue require modification of the concept in two types of exchanges. They therefore conclude that:

a. Fair values should not be recognized if an enterprise exchanges product or property held for sale in the ordinary course of business for product or property to be sold in the same line of business. The emphasis in that exchange, in their view, is on developing economical ways to acquire inventory for resale to customers rather than on marketing inventory to obtain revenue from customers. Therefore, "swapping" inventories between enterprises that are essentially competitors and not customers of each other is merely an incidental early stage of an earning process, and revenue should not be recognized until the time of sale of the exchanged products (in the same or another form) to a customer of the enterprise.

b. Fair value should not be recognized if an enterprise exchanges a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset. Therefore, revenue should not be recognized merely because one productive asset is substituted for a similar productive asset but rather should be considered to flow from the production and sale of the goods or services to which the substituted productive asset is committed.

17. **Fair Value Not Determinable.** General agreement exists that a nonmonetary transaction, regardless of form, should not be recorded at fair value if fair value is not determinable within reasonable limits. Major uncertainties concerning realizability of the fair value proposed to be assigned to a nonmonetary asset received in a nonmonetary transaction are indicative of an inability to determine fair value within reasonable limits. Some believe that only an exchange transaction between parties with essentially opposing interests provides an independent test of fair value to be used in measuring the transaction; therefore fair value is determinable within reasonable limits only in a negotiated exchange transaction. Others believe that fair value in a nonreciprocal transfer is also often determinable within reasonable limits and should be recognized in certain types of transactions.

**OPINION**

**Basic Principle**

18. The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).
19. The Board believes that certain modifications of the basic principle are required to accommodate problems of measurement and questions about the conditions for recognizing revenue. These modifications are specified in paragraphs 20 to 23.

Modifications of the Basic Principle

20. A nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset(s) relinquished, and not on the fair values of the exchanged assets, if any of the following conditions apply:

a. Fair Value Not Determinable. The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits (paragraph 25).

b. Exchange Transaction to Facilitate Sales to Customers. The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.

c. Exchange Transaction That Lacks Commercial Substance. The transaction lacks commercial substance (paragraph 21).

Commercial Substance

21. A nonmonetary exchange has commercial substance if the entity's future cash flows are expected to significantly change as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria is met:

a. The configuration (risk, timing, and amount) of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.

b. The entity-specific value of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.

5 See paragraph 25 for determination of fair value.

5a An indicated impairment of value of a long-lived asset within the scope of Statement 144 shall be determined in accordance with paragraph 29 of that Statement.

5b FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, contains guidance that may be useful in evaluating changes in future cash flows.

5c The configuration of future cash flows is composed of the risk, timing, and amount of the cash flows. A change in any one of those elements would be a change in configuration.

5d The configuration of future cash flows is composed of the risk, timing, and amount of the cash flows. A change in any one of those elements would be a change in configuration.
5d An entity-specific value (referred to as an entity-specific measurement in Concepts Statement 7) is different from a fair value measurement. As described in paragraph 24(b) of Concepts Statement 7, an entity-specific value attempts to capture the value of an asset or liability in the context of a particular entity. For example, an entity computing an entity-specific value of an asset would use its expectations about its use of that asset rather than the use assumed by marketplace participants. If it is determined that the transaction has commercial substance, the exchange would be measured at fair value, rather than at the entity-specific value.

A qualitative assessment will, in some cases, be conclusive in determining that the estimated cash flows of the entity are expected to significantly change as a result of the exchange.

6 [This footnote has been deleted. See Status page.]

21A. In the United States and some other tax jurisdictions, a transaction is not given effect for tax purposes unless it serves a legitimate business purpose other than tax avoidance. In assessing the commercial substance of an exchange, tax cash flows that arise solely because the tax business purpose is based on achieving a specified financial reporting result shall not be considered.

22. The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraph 21) may include an amount of monetary consideration. The Board believes that the recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. The Board further believes that the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraph 21 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraph 21, the entire indicated loss on the exchange should be recognized.

23. Nonreciprocal Transfers to Owners. Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary assets distributed. A prorata distribution to owners of a subsidiary of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.
Applying the Basic Principle

24. The Board's conclusions modify to some extent existing practices as described in paragraphs 5 to 7. The conclusions are based on supporting reasons given in paragraphs 8 to 17.

25. Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

26. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value. An exchange involving parties with essentially opposing interests is not considered a prerequisite to determining a fair value of a nonmonetary asset transferred; nor does an exchange insure that a fair value for accounting purposes can be ascertained within reasonable limits. If neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the enterprise may be the only available measure of the transaction.

27. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for according to FASB Statement No. 109, Accounting for Income Taxes.

Disclosure

28. An enterprise that engages in one or more nonmonetary transactions during a period should disclose in financial statements for the period the nature of the transactions, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.  

37. ARB 43, Chapter 7, Section B provides the following guidance (only the pertinent excerpts are included below):

As to the Recipient

5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this chapter. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.
6. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the separate entity concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known. The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in Eisner v. Macomber, 252 U.S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

"A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased . . . the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

38. FIN 30 provides the following guidance (only the pertinent excerpts are included below):

1. The FASB has been asked whether gain or loss results from an involuntary conversion of a nonmonetary asset to monetary assets if the monetary assets are subsequently reinvested in a similar nonmonetary asset. Generally, if a nonmonetary asset is involuntarily converted, gain or loss for the difference between the cost of the nonmonetary asset and the amount of monetary assets received has been recognized in income in the period of the involuntary conversion. In other cases, that difference has been accounted for as an adjustment to the cost basis of a nonmonetary asset that is subsequently acquired as replacement property.

1 The terms "nonmonetary" and "monetary" as used in this Interpretation have the same meaning as those terms have in APB Opinion No. 29, Accounting for Nonmonetary Transactions.
INTERPRETATION

2. As used in this Interpretation, the term cost refers to the cost of a nonmonetary asset or to its carrying amount, if different.

3. Paragraph 14(b) of APB Opinion No. 28, Interim Financial Reporting, provides an exception for the liquidation of a LIFO inventory at an interim date if replacement is expected by year-end. Accordingly, that exception applies to an involuntary conversion of a LIFO inventory if replacement is expected by year-end.

39. EITF 86-29 provides the following guidance (only the pertinent excerpts are included below):

ISSUE

The basic principle contained in Opinion 29 is that the exchange of nonmonetary assets should be recorded at fair value. Certain modifications to that basic principle are contained in paragraphs 21 and 22 of Opinion 29. (The Task Force previously discussed certain aspects of those modifications in Issues No. 84-29, "Gain and Loss Recognition on Exchanges of Productive Assets and the Effect of Boot," and No. 85-43, "Sale of Subsidiary for Equity Interest in Buyer.")

The issues are (1) how the accounting for certain nonmonetary transactions should be affected by the magnitude of boot and (2) how the exceptions to the use of fair value should be applied.

EITF DISCUSSION

The Task Force reached a consensus that the decision as to whether an exchange involving products or properties held for sale (paragraph 21(a) of Opinion 29) should be measured using the recorded amounts or fair value depends on whether the products or properties received will be sold in the same line of business as the products or properties given up.
Further, the Task Force reached a consensus that the decision as to whether an exchange of similar productive assets (paragraph 21(b)) should be measured using the recorded amounts or fair value should be based on a "same line of business" test.

Some Task Force members expressed the view that the exchange of a controlled business (as defined in ARB 51) for an investment in an entity that is not controlled, but is in the same line of business, would not necessarily meet the definition of a similar productive asset and would have to be evaluated based on individual facts and circumstances. No consensus was reached on this issue.

The Task Force reached a consensus that a product or property held for sale and exchanged for a productive asset did not fall within the modifications to the basic principle of Opinion 29 (even if they were in the same line of business) and should be recorded at fair value.

The Task Force discussed an exchange of nonmonetary assets that would otherwise be based on recorded amounts but that also involves boot, reached a consensus that the transaction should be considered monetary (rather than nonmonetary) if the boot is significant, and agreed that "significant" should be defined as at least 25 percent of the fair value of the exchange. As a monetary transaction, both parties would record the exchange at fair value. If the boot in a transaction is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 should be applied by the receiver of boot, and the payer of boot would not recognize a gain. The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite to the use of fair value.

The Task Force also discussed various exchanges involving investments accounted for by consolidation and by the equity method. The Task Force reached a consensus that an enterprise should account for an exchange of securities in which it acquires control of a subsidiary as a business combination in accordance with Opinion 16. An enterprise should account for an exchange of securities accounted for by consolidation or by the equity method for an investment in which it does not acquire control of a business but for which it will account by the equity method, as a nonmonetary transaction in accordance with Opinion 29. The Task Force noted that the provisions of this consensus were not intended to apply to exchanges involving joint ventures or the acquisition of a minority interest.

Additionally, several Task Force members and the SEC Observer expressed concern that a literal application of the consensus to an exchange in which an enterprise acquires control of a business could result in the recognition of gain on transactions that are in substance an exchange of similar productive assets or result in a 100 percent write-up of an asset in circumstances in which an entity has not transferred control of the asset. For example, Company A transfers an asset to Company B in exchange for shares of Company B. As a result of the exchange, Company A acquires control of Company B; Company A also indirectly retains control of the asset received by Company B. The Task Force agreed that Company A should account for this transaction as a partial sale (to minority shareholders of Company B), and gain recognition should be limited to that portion of the asset treated as sold. If Company B accounts for the exchange at fair value, profit applicable to the portion of the asset indirectly controlled by Company A would be eliminated in Company A's consolidation of Company B.

Further, the Task Force observed that the consensus is not intended to change the application of Opinion 16 or to eliminate the need to exercise judgment in those circumstances in which the substance of a transaction indicates that fair value accounting is not appropriate. That is, if Opinion 16 is to apply, the substance of the transaction must be a business combination.

STATUS

Issues relating to the exchange of real estate involving boot were discussed in Issue No. 87-29, "Exchange of Real Estate Involving Boot." For that issue, the Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 86-29 because boot is at least 25 percent of the fair value of the
exchange would be allocated between two components: a monetary portion and a nonmonetary portion. (An exchange of similar real estate is defined in Issue 87-29 as an exchange of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate.) The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. For the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. Exhibit 87-29A presents an example of the application of the consensus reached on Issue 87-29.

No further EITF discussion is planned.

40. EITF 93-11 provides the following guidance (only the pertinent excerpts are included below):

**ISSUE**

In a barter transaction involving barter credits, an enterprise enters into a transaction to exchange a nonmonetary asset (for example, inventory) for barter credits. Those transactions may occur directly between principals to the transaction or include a third party whose business is to facilitate those types of exchanges (for example, a barter company).

The barter credits can be used to purchase goods or services, such as advertising time, from either the barter company or members of its barter exchange network. The goods and services to be purchased may be specified in a barter contract or limited to items made available by members of the exchange network. Some arrangements may require the payment of cash in addition to the barter credits to purchase goods or services. Barter credits also may have a contractual expiration date, at which time they become worthless.

The issue is whether Opinion 29 should be applied to an exchange of a nonmonetary asset for barter credits and, if so, the amount of profit or loss, if any, that should be recognized.

**EITF DISCUSSION**

The Task Force reached a consensus that transactions in which nonmonetary assets are exchanged for barter credits should be accounted for under Opinion 29. An impairment of the nonmonetary asset exchanged should be recognized prior to recording the exchange if the fair value of that asset is less than its carrying amount. The impairment should be measured as the amount by which the carrying amount of the asset exceeds its fair value. Recognition of an impairment loss also would be required in an exchange of assets or contractual rights not reported in the balance sheet (for example, operating leases) if the transferor is not relieved of primary liability for the related obligation. The definition of fair value in paragraph 13 of Statement 15 may be useful in determining the fair value of the nonmonetary asset. The Task Force noted that fair value should not be based on an estimate of the value of the barter credits to be received. After an impairment is recognized, the reduced carrying amount of the nonmonetary asset becomes its new cost. [Note: See STATUS section.]

If an exchange involves the transfer or assumption of an operating lease, impairment of that lease should be measured as the amount of the remaining lease costs (discounted rental payments and unamortized leasehold improvements) in excess of the discounted amount of probable sublease rentals for the remaining lease term. [Note: See STATUS section.]

The Task Force also reached a consensus that in reporting the exchange of a nonmonetary asset for barter credits, it should be presumed that the fair value of the nonmonetary asset exchanged is more clearly evident than the fair value of the barter credits received and that the barter credits should be reported at the fair value of the nonmonetary asset exchanged. The Task Force noted, however, that that presumption might be overcome if an entity can convert the barter credits into
cash in the near term, as evidenced by a historical practice of converting barter credits into cash shortly after receipt, or if independent quoted market prices exist for items to be received upon exchange of the barter credits. It also should be presumed that the fair value of the nonmonetary asset does not exceed its carrying amount unless there is persuasive evidence supporting a higher value. An impairment loss on the barter credits should be recognized if it subsequently becomes apparent that (1) the fair value of any remaining barter credits is less than the carrying amount or (2) it is probable that the enterprise will not use all of the remaining barter credits.

STATUS

In March 1995, the FASB issued Statement 121 which requires that long-lived assets and certain identifiable intangibles to be held and used be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Statement 121 establishes accounting standards for the recognition and measurement of impairment losses and sets forth an approach to determining an asset's fair value. Statement 121 also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell.

In August 2001, the FASB issued Statement 144. Statement 144 addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed of and supersedes Statement 121.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy,
- SSAP No. 5—Liabilities, Contingencies and Impairments of Assets,
- SSAP No. 10—Income Taxes,
- SSAP No. 12—Employee Stock Ownership Plans,
- SSAP No. 13—Stock Options and Stock Purchase Plans,
- SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties,
- SSAP No. 28—Nonmonetary Transactions,
- SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities),
- SSAP No. 68—Business Combinations and Goodwill,
- SSAP No. 72—Surplus and Quasi-Reorganizations,
- SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,
- INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments,
- INT 00-12: EITF 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company,
- INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or of a Business,
- INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions, and
- INT 03-16: Contribution of Stock

Generally Accepted Accounting Principles

- Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, paragraph 16,
- Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions,
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 7, Section B, Stock Dividends and Stock Split-ups,
- FASB No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29,
- FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets,
- FASB Emerging Issues Task Force Issue No. 86-29: Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value,
- FASB Emerging Issues Task Force Issue No. 93-11: Accounting for Barter Transactions Involving Barter Credits,
- FASB Emerging Issues Task Force Issue No. 96-4: Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners,
- FASB Emerging Issues Task Force Issue No. 98-3: Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business
- FASB Emerging Issues Task Force Issue No. 98-7: Accounting for Exchanges of Similar Equity Method Investments,
- FASB Emerging Issues Task Force Issue No. 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company, and

STATE REGULATIONS

- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 128

Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

STATUS:
Finalized June 12, 2006

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance relating to intercompany transactions is included in SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25). SSAP No. 25 does not explicitly impose an aging threshold for admission of loans and advances to related parties outstanding as of the reporting date. In addition, no explicit aging threshold exists for admission of receivables associated with transactions for services provided to related parties outstanding as of the reporting date.

2. While SSAP No. 25 established statutory accounting principles and disclosure requirements for related party transactions, the purpose of this issue paper is to amend this guidance to include an explicit aging threshold for admissibility for these transactions. A threshold will further clarify the current requirement in paragraph 6 of SSAP No. 25 regarding the maintenance of accounts “on a current basis.” In addition, a threshold provides explicit parameters in which to apply the fair and reasonable standard established by Appendix A-440, which is referenced in paragraph 15, of SSAP No. 25.

SUMMARY CONCLUSION

3. This issue paper shall amend SSAP No. 25 to insert the following additional paragraph numbered six and to renumber the remaining paragraphs of the statement:

Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted. If the due date is not addressed by the written agreement any uncollected receivable is nonadmitted.

Disclosures

4. This issue paper requires no additional disclosures.

Effective Date and Transition

5. After adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2007.
DISCUSSION

6. This issue paper will help ensure transactions between the reporting entity and its parent, affiliates and related parties, are current. This inclusion of a 90-day rule is consistent with other statements of statutory accounting principles.

Drafting Notes/Comments

7. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. The concept of an aging threshold for admissibility (i.e., 90-day rule) is contained in SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers (SSAP No. 6) as follows:

9. Nonadmitted amounts are determined as follows:

   a. Uncollected Premium—To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be nonadmitted. 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 nonadmitted;

   b. Bills Receivable—Bills receivable shall be nonadmitted if either of the following conditions are present:

      i. If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or

      ii. If the bills receivable balance due exceeds the unearned premium on the policy for which the note was accepted, the amount in excess of the unearned premium is nonadmitted.

   c. Agents' Balances—The uncollected agent's receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium;

      i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance due, by agent;

      If reconciling items between a reporting entity's account and an agent's account are over ninety days due, the amounts shall be nonadmitted.

9. This aging concept is also include in SSAP No. 10—Income Taxes (SSAP No. 10) as follows:

13. Amounts owed to a reporting entity pursuant to a recognized transaction shall be treated as a loan or advance, and nonadmitted, pursuant to SSAP No. 25, to the extent that the recoverable is not settled within 90 days of the filing of a consolidated income tax return, or where a refund is due the reporting entity's parent, within 90 days of the receipt of such refund.

Generally Accepted Accounting Principles

10. GAAP does not address the concept of admitted assets.
RELEVANT LITERATURE

Statutory Accounting
- SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

Generally Accepted Accounting Principles
- None

State Regulations
- No additional guidance obtained from state statutes or regulations.
EXHIBIT A: Illustration of Marked Changes to Amended SSAP No. 25

The following depicts the amendment made by this issue paper as “marked changes”: (new text underlined):

SCOPE OF STATEMENT

1. Related party transactions are subject to abuse 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. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

SUMMARY CONCLUSION

2. Related parties are defined as entities that have common interests as a result of ownership, control, 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 3;

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


3. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48). Those entities are accounted for under the...
Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

IP No. 128

guidance provided in SSAP No. 48, which requires an equity method for all such investments. 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.

4. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) contract other than a commercial contract for goods or nonmanagement services, (c) 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.

5. Control as defined in paragraph 4 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. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

   a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
   
   b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
   
   c. An entity where the insurer has given up participation rights¹ as a shareholder to the investee.

6. Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted. If the due date is not addressed by the written agreement any uncollected receivable is nonadmitted.

Related Party Loans

6.7 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

¹ The term “participating rights” refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as “protective rights”. Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in EITF 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 term “participating rights” shall be used consistent with the discussion of substantive participating rights in the EITF.
advances shall be made periodically. If, in accordance with SSAP No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (SSAP No. 5), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

7.8. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 10. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 10 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

8.9. 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.

9.10. 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 6. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraphs 7 and 8.

Transactions Involving the Exchange of Assets or Liabilities

10.11. 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 is defined as an arm's-length transaction which results in the transfer of the 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 SSAP 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, not the form of the transaction.

11.12. 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.

12. 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 fair 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 (fair 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.

13. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 12, 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.

14. 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 12);

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 it's 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 reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.
Examples of transactions 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

45-16. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm's length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or 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 are generally subject to regulatory approval.

46-17. 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, or (d) 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 SSAP No. 70—Allocation of Expenses for additional discussion regarding the allocation of expenses.

Disclosures

47-18. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions 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, any non-insurance transactions which involve less than 1/2 of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

i. Date of transaction;

ii. Explanation of transaction;

iii. Name of reporting entity;

iv. Name of affiliate;

v. Description of assets received by reporting entity;

vi. Statement value of assets received by reporting entity;

vii. Description of assets transferred by reporting entity; and
viii. 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; and

h. The amount deducted from the value of an upstream intermediate entity or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated entity, in accordance with the Purposes and Procedures Manual of the NAIC Securities Valuation Office, "Procedures for Valuing Common Stocks and Stock Warrants."

18.19. Refer to the preamble for further discussion regarding disclosure requirements.

**Relevant Literature**

19.20. This statement adopts FASB Statement No. 57, Related Party Disclosures with a modification to paragraph 2 to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business.

20-21. This statement rejects AICPA Accounting Interpretations, Business Combinations: Accounting Interpretations of APB Opinion No. 16, #39, "Transfers and Exchanges Between Companies Under Common Control".

**Effective Date and Transition**

22. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.
Statutory Issue Paper No. 131

Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment

STATUS:
Finalized March 29, 2008

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. In November of 2005, the FASB issued FSP FAS 115-1/124-1: The Meaning of Other-Than- Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1/124-1) to address several issues related other-than-temporary impairment for investments. In December of 2006, the Emerging Accounting Issues Working Group of the NAIC released INT 06-07: Definition of Phrase “Other Than Temporary” (INT 06-07), which addressed all but two issues contained within FSP FAS 115-1/124-1. The purpose of this issue paper is to address one of those remaining issues, specifically the guidance provided in paragraph 16 of FSP FAS 115-1/124-1 regarding treatment of premium or discount for a debt security subsequent to other-than-temporary impairment recognition.

2. Current statutory guidance on accounting for impairment of debt securities, amortization of premium and accrual of discount is provided in SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities (SSAP No. 26), SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities) (SSAP No. 32), SSAP No. 34—Investment Income Due and Accrued (SSAP No. 34), and SSAP No. 43—Loan-backed and Structured Securities (SSAP No. 43).

3. Subsequent to recognition of an other-than-temporary impairment for a debt security, the GAAP guidance in FSP FAS 115-1/124-1 requires that a reporting entity account for the security as if the security had been purchased on the measurement date of the other-than-temporary impairment. As such, the recorded discount or reduced premium should be amortized over the remaining life of the security in a prospective manner based on the amount and timing of future estimated cash flows. Statutory accounting statements currently contain no explicit guidance on the issue of whether to continue amortization of premium or accrual of discount subsequent to other-than-temporary impairment recognition.

SUMMARY CONCLUSION

4. This issue paper adopts the guidance in paragraph 16 of FSP FAS 115-1/124-1, with modification to the applicable statutory accounting statements to be consistent with the statutory language in each respective statement as indicated in the following paragraphs.

Bonds, excluding Loan-backed and Structured Securities

5. The guidance in paragraphs 6 and 7 of this issue paper shall supersede the guidance in paragraph 9 of SSAP No. 26.

Impairment

6. An other-than-temporary 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 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. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bonds carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. Credit related other-than-temporary impairment losses shall be recorded through the AVR; interest related other-than-temporary impairment losses shall be recorded through the IMR.

7. In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Preferred Stock

8. The guidance in paragraphs 9 through 12 of this issue paper shall supersede the guidance in paragraphs 22 through 24 of SSAP No. 32.

Impairment of Redeemable Preferred Stock

9. An other-than-temporary 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 the security in effect at the date of acquisition. A decline in fair value which is other-than-temporary includes situations where the 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). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock’s carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserves.

10. In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 18 or paragraph 20 of SSAP No. 32, as applicable. The fair value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.
Impairment of Perpetual Preferred Stock

11. If it is determined that a decline in the fair value of a perpetual preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock’s carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.

12. In periods subsequent to the recognition of an other-than-temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 19 or paragraph 21 of SSAP No. 32, as applicable. The fair value of the perpetual preferred stock on the measurement date shall become the new cost basis of the perpetual preferred stock and the new cost basis shall not be adjusted 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.

Investment Income Due and Accrued

13. The guidance in SSAP No. 34, paragraph 3, shall be modified by this issue paper as follows:

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.) Immediate amortization of premium which occurs upon recognition of an other-than-temporary impairment loss for a debt security with a recorded premium shall be reported as a realized loss and shall not be included in investment income.

Loan-backed and Structured Securities

14. This issue paper shall insert the following new paragraph 17 into SSAP No. 43, with subsequent paragraphs of SSAP No. 43 to be renumbered accordingly:

17. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. 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 impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Disclosures

15. This issue paper requires no additional disclosures.
Relevant Literature

16. This issue paper adopts FSP FAS 115-1/124-1, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

Effective Date and Transition

17. After adoption of this issue paper, it is expected that the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. To allow time for any necessary system related changes, it is expected that the SSAP will be effective for reporting periods ending on or after December 31, 2008.

DISCUSSION

18. Though statutory accounting statements include instructions on accounting for impaired debt securities, guidance is currently silent regarding the treatment of premium or discount subsequent to recognition of an other-than-temporary impairment loss. Prior to issuance of FSP FAS 115-1/124-1, GAAP guidance was also silent on the issue. This has led to inconsistent accounting practices.

19. The FASB guidance requires that amortization of premium or accrual of discount continues in periods subsequent to other-than-temporary impairment recognition. Statutory accounting guidance should provide for consistent accounting treatment in this subsequent period, and there appears to be no compelling reason for statutory guidance to diverge from GAAP on this issue. As such, this issue paper adopts the GAAP guidance contained in FSP FAS 115-1/124-1, paragraph 16, with modifications to be consistent with existing statutory accounting language.

20. The term “cost” is used in GAAP for evaluation, measurement and subsequent accounting treatment related to impairment of debt securities. FSP FAS 115-1 / 124-1, footnote 2 to paragraph 7, defines cost to include adjustments made to the cost basis of an investment for accretion, amortization, previous other-than-temporary impairments, and hedging. Based on this definition, cost for GAAP purposes would be the equivalent of the book adjusted carrying value relevant to statutory accounting.

21. The guidance adopted by this issue paper requires that subsequent to impairment recognition, a debt security be accounted for as if the security had been purchased on the measurement date of the other-than-temporary impairment. For debt securities carried with unamortized premium, the impairment loss is first applied to any unamortized premium, and the reduced premium is amortized over the remaining life of the security in a prospective manner based on the amount and timing of future estimated cash flows. If an impairment loss is so significant that the unamortized premium is fully expensed upon recognition of the realized loss, any remaining impairment loss is applied to the cost of the security and amortization would no longer be applicable.

22. For securities carried with unaccrued discount, the impairment loss is recorded as a reduction of cost, with no effect on the unaccrued discount. The sum of the new cost basis plus the unaccrued discount becomes the maximum amortized value, or the maximum value to which the security is allowed to be accreted. The unaccrued discount is then accreted over the remaining life of the security based on the amount and timing of future estimated cash flows. As the carrying value shall not be adjusted for subsequent recoveries in fair value, the book adjusted carrying value shall not exceed the maximum amortized value during the remaining life of the security.
23. This exposure draft also includes clarifying guidance for SSAP No. 26 regarding the proper recording of impairment losses for reporting entities required to maintain an Asset Valuation Reserve (AVR) and an Interest Maintenance Reserve (IMR). The language was added to paragraph 6 of this issue paper to clarify that for reporting entities required to maintain such reserves, credit related other-than-temporary impairment losses are to be recorded through the AVR, while interest related other-than-temporary impairment losses are to be recorded through the IMR.

24. The guidance adopted by this issue paper is consistent with the concepts of statutory accounting.

Drafting Notes/Comments

25. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

26. Statutory guidance for amortization of premium, accrual of discount, and impairment for bonds, excluding loan-backed and structured securities, is provided in SSAP No. 26:

Amortized Cost

6. 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).

Impairment

9. If it is determined that a decline in the fair value of a bond is other than temporary, the cost basis of the bond shall be written down to fair 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 value. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair 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.

27. Statutory guidance for amortization of premium, accrual of discount, and impairment for preferred stock is provided in SSAP No. 32:

Amortization

12. 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 (yield to worst). 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.

13. PIK preferred stock shall be amortized to the lower of the call price or 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.
14. Amortization shall be calculated using the interest method and shall be reported as increases or decreases in dividends collected during the year.

**Impairment**

22. If it is determined that a decline in the fair value of a preferred stock is other than temporary, the preferred stock shall be written down to fair value as a 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 SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.

23. Perpetual preferred stock shall be accounted for in accordance with paragraph 19 or paragraph 21, as applicable, subsequent to the recognition of an other than temporary impairment. Future declines in fair 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 the reporting entity has made a decision to sell a security at an amount below its carrying value.

24. Redeemable preferred stock shall be accounted for in accordance with paragraph 18 or paragraph 20, as applicable, subsequent to the recognition of an other than temporary impairment. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the security in effect at the date of acquisition. A decline in fair value which is other than temporary includes situations where the 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).

28. Statutory guidance in SSAP No. 34 provides items to be included in gross investment income:

**SCOPE OF STATEMENT**

1. This statement establishes statutory accounting principles for investment income due and accrued.

**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.).

4. Investment income due and accrued shall be recorded as an asset in accordance with SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4). An evaluation shall be made of such assets in accordance with SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP 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.

5. This two step process is set forth below.

   a. Investment income due and accrued shall be assessed for collectibility. If, in accordance with SSAP 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 Accounting Practices and Procedures Manual as nonadmitted shall be considered nonadmitted assets and recognized through a direct charge to surplus in accordance with SSAP 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.

6. Accrued interest on mortgage loans that are in default (as defined in SSAP 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 5 a. above. If a mortgage loan in default has interest 180 days past due which has been assessed as collectible, all interest shall be considered a nonadmitted asset and recognized through a direct charge to surplus as outlined in paragraph 5 b. above.

29. Statutory guidance for amortization of premium, accrual of discount, and impairment for loan-backed and structured securities is provided in SSAP No. 43:

**Amortization**

7. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded 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 repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

**Impairment**

16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined an other than temporary impairment has occurred, the cost basis of the 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. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. 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.

**Generally Accepted Accounting Principles**

30. FSP FAS 115-1/124-1, paragraph 16 contains the GAAP guidance which is addressed by this issue paper:

**Accounting for Debt Securities Subsequent to an Other-Than-Temporary Impairment**

16. In periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, an investor shall account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment. That is, the discount or reduced premium recorded for the debt security, based on the new cost basis, would be amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows.
31. Footnote 2 to paragraph 7 of FSP FAS 115-1/124-1, provides the GAAP definition of cost, which is used in impairment evaluation:

Cost includes adjustments made to the cost basis of an investment for accretion, amortization, previous other-than-temporary impairments, and hedging.

RELEVANT LITERATURE

Statutory Accounting
- 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)
- SSAP No. 43—Loan-backed and Structured Securities

Generally Accepted Accounting Principles
- FASB Staff Position FAS 115-1/124-1

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 134

Servicing Assets/Liabilities, An Amendment of SSAP No. 91

STATUS:
Finalized March 29, 2008

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. In March 2006, the Financial Accounting Standards Board (FASB) issued *FASB Statement No. 156: Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140* (FAS 156) to amend several aspects of accounting for servicing assets. The purpose of this issue paper is to incorporate and/or clarify specific amendments from FAS 156 into statutory accounting principles:
   a. Require subsequent fair value measurement of servicing assets and servicing liabilities;
   b. Clarify separate recognition of servicing assets and servicing liabilities resulting from a transfer of financial assets to a qualifying SPE in guaranteed mortgage securitizations in which the transferor retains all of the resulting securities;
   c. Include separately recognized servicing assets and servicing liabilities in the calculation for determining proceeds from the sale of assets; and
   d. Incorporate revised terminology, amending the term ‘retained interests’ to ‘interests that continue to be held by a transferor’.

2. Current statutory accounting guidance for servicing assets and servicing liabilities is located within *SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91). The conclusions reached within SSAP No. 91 resulted from adoption with modification of *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140).

3. The purpose of this issue paper is to update statutory accounting principles for servicing assets and servicing liabilities. The result will be the incorporation of substantive and nonsubstantive revisions to SSAP No. 91. In accordance with the *NAIC Policy Statement on Statutory Accounting Principles Maintenance Agenda Process* (Maintenance Agenda Policy Statement), substantive revisions require the issuance of a new SSAP. However, as only some aspects of the revisions from FAS 156 are considered substantive, it is requested that the Statutory Accounting Principles Working Group approve the exposure of the adopted FAS 156 revisions within the existing SSAP No. 91, after the adoption of this issue paper.

SUMMARY CONCLUSION

4. This issue paper adopts revisions to FAS 156 indicating that all servicing assets and servicing liabilities should initially be measured at fair value. Consistent with these revisions, this issue paper adopts guidance from FAS 156 requiring the inclusion of separately recognized servicing assets and servicing liabilities in the calculation of proceeds from the sale of assets and modifies the illustrations included within SSAP No. 91 accordingly. This issue paper rejects the optionality provided within FAS
156 for subsequent measurement of servicing assets and servicing liabilities, but revises the SSAP No. 91 accounting measurement method for such items to a fair value measurement method. This issue paper confirms adoption of guidance previously adopted from FAS 140 regarding servicing assets and servicing liabilities established from the transfer of financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities. This issue paper also adopts nonsubstantive revisions from FAS 156 in which the term ‘retained interests’ is replaced with ‘interests that continue to be held by the transferor’, with amendments to the definition to exclude servicing assets and servicing liabilities.

5. Substantive revisions to SSAP No. 91 from this issue paper are illustrated below:

6. Upon completion of any transfer of financial assets, the transferor shall:
   a. Initially recognize and measure at fair value, if practicable, servicing assets and servicing liabilities assumed under a separate contractual obligation to service financial assets (see paragraph 49);
   b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, interests that continue to be held by a transferor, if any, based on their relative fair values at the date of transfer (see paragraphs 47 and 48).
   c. Continue to carry in its balance sheet any retained interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and retained undivided interests (see paragraphs 7 c., 47 and 48); and

Recognition and Measurement of Servicing Assets and Liabilities

11. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. Servicing rights become a distinct asset or liability of the reporting entity pursuant to:
   a. A transfer of the servicer’s financial assets that meets the requirements for sale accounting;
   b. A transfer of financial assets to a qualifying SPE in a guaranteed mortgage obligation in which the transferor retains all of the resulting securities; or
   c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer.

A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying assets remaining on the transferor’s balance sheet shall not be recognized as a servicing asset or servicing liability.

12. (New paragraph – renumbering accordingly) If distinct servicing rights to transferred assets exist in accordance with the above guidelines and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income.

Servicing assets and servicing liabilities it shall be measured initially at its fair value, presumptively the price paid. The servicing assets or liabilities shall be measured subsequently at fair value at each reporting date with fluctuations in
Servicing Assets/Liabilities, An Amendment of SSAP No. 91

IP No. 134

fair value reported as unrealized gains or losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses, shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.

Assets Obtained and Liabilities Incurred as Proceeds

46. The proceeds from a sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. 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.

Disclosures

88. A reporting entity shall disclose the following:

j. For all servicing assets and servicing liabilities:

i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and

A description of the valuation techniques or other models, including significant assumptions within models, used to estimate the fair value of servicing assets and servicing liabilities.

ii. The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

Changes in fair value resulting from changes in valuation inputs or assumptions used in models and descriptions of other changes in fair value.

6. SSAP No. 91, Exhibit B provides illustrations to assist with the accounting of items subject to this standard. Pursuant to the substantive revisions noted above to paragraph 46 of SSAP No. 91, the proceeds from the sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets. Exhibit B illustrations three, four and five have been modified to convey these revisions:

Illustration—Sale of Receivables with Servicing Retained

3. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is $1,100. The fair values of the servicing asset and the interest-only strip receivable are $40 and $60, respectively.

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<tr>
<td>Interest-only strip receivable</td>
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IP 134-3
### Net Proceeds

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<td>Servicing asset</td>
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Net Proceeds $1,040

### Carrying Amount Based on Relative Fair Values

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### Gain on Sale

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### Journal Entries

**Cash 1,000**  
**Interest-only strip receivable 54.50**  
**Servicing Asset 40**  
**Loans 910,000**  

**Gain on sale 9094.50**  
*To record transfer and to recognize interest-only strip receivable and servicing asset*

**Servicing asset 36**  
**Interest-only strip receivable 54**  
**Loans 90**  

*To record servicing asset and interest-only strip receivable*

**Interest-only strip receivable 65.50**  
**Equity 65.50**  

*To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140, paragraph 14)*

### Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

4. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans. *At the date of transfer, the fair value of the loans is $1,100.*
**Fair values**
- Cash proceeds: $900
- Call option: 70
- Recourse obligation: 60
- Servicing asset: 90
- One-tenth interest retained: 100

**Net Proceeds**
- Cash received: $900
- Plus: Servicing Asset 90
- Plus: Call option 70
- Less: Recourse obligation (60)
- Net proceeds: $910

**Carrying Amount Based on Relative Fair Values**

<table>
<thead>
<tr>
<th>Interest sold</th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest sold</td>
<td>$910,000</td>
<td>83.9%</td>
<td>$830,909</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>90</td>
<td>8%</td>
<td>80</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>100</td>
<td>9.1%</td>
<td>909</td>
</tr>
<tr>
<td>Total</td>
<td>$1,100</td>
<td>100%</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Gain on Sale**
- Net proceeds: $910,000
- Less: Carrying amount of loans sold: $830,909
- Gain on sale: $8091

**Loans Sold**
- Carrying Amount of Loans: $1,000
- Less: Allocated carrying amount of interest that continues to be held by the transferor: (91)
- Loans Sold: $909

**Journal Entries**
- Cash: 900
- Call option: 70
- Servicing Asset: 90
- Loans: $830,909
- Recourse obligation: 60
- Gain on sale: $8091

To record transfer and to recognize servicing asset, call option and recourse obligation.

- Servicing asset: 80
- Loans: 80

To record servicing asset.
At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

5. Company E sells loans with a carrying amount of $1,000 to another entity for cash proceeds of $1,050 plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes an obligation to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

<table>
<thead>
<tr>
<th>Fair Values</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>XX*</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>XX*</td>
</tr>
<tr>
<td>Fair value of loans transferred</td>
<td>1,100</td>
<td>1,100</td>
</tr>
</tbody>
</table>

* Not practicable to estimate fair value

<table>
<thead>
<tr>
<th>Net Proceeds</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Servicing Asset</td>
<td>XX*</td>
<td>40</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
<td>XX</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,060</td>
<td>$1,129,116</td>
</tr>
</tbody>
</table>

Carrying Amount Based on Relative Fair Values (Case 1)

<table>
<thead>
<tr>
<th>Loans sold</th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,060</td>
<td>100</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$1,060</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Carrying Amount Based on Relative Fair Values (Case 2)

<table>
<thead>
<tr>
<th>Loans sold</th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,120</td>
<td>97</td>
<td>$970</td>
<td></td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
<td>3</td>
<td>30</td>
</tr>
<tr>
<td>Total</td>
<td>$1,160</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Gain on Sale

<table>
<thead>
<tr>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,060</td>
</tr>
<tr>
<td>Carrying Amount of Loans</td>
<td>1,000</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>0</td>
</tr>
<tr>
<td>Gain on Sale</td>
<td>$60</td>
</tr>
</tbody>
</table>
Journal Entries

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,050</td>
<td>1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0*</td>
<td>3040</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Loans</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>1560†</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>60</td>
<td>0</td>
</tr>
<tr>
<td>To record transfer</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.
† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

Effective Date and Transition

7. Upon adoption of this issue paper, the NAIC will release an updated Statement of Statutory Accounting Principle (SSAP) No. 91 for comment. The SSAP will contain the adopted nonsubstantive changes to SSAP No. 91, shown in this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2009.

DISCUSSION

Initial Recognition and Measurement of Fair Value

8. Revisions to FAS 156 amended guidance regarding how servicing assets and servicing liabilities should be initially recognized and measured. FAS 140 requirements for initial measurement of servicing assets and servicing liabilities varied depending on whether they were purchased separately, assumed, or obtained in a sale or securitization transaction, as well as whether they were assets or liabilities. The revisions in FAS 156 clarified that servicing assets and servicing liabilities should be accounted for similarly, regardless of how they are obtained and that fair value is the most relevant measurement attribute.

9. For statutory accounting, guidance within SSAP No. 91 had previously adopted guidance within paragraph 13 of FAS 140 requiring initial fair value measurement for purchased and assumed servicing assets and servicing liabilities. Similar to GAAP rationale for FAS 156, it is appropriate for statutory accounting that all servicing assets and servicing liabilities be accounted for similarly. As such, this issue paper adopts the FAS 156 guidance that all servicing assets and servicing liabilities should be initially measured at fair value, regardless if such items are purchased, assumed, or undertaken in a sale or securitization.

10. Pursuant to the FAS 156 revisions to initially measure all servicing assets and liabilities at fair value, revisions were incorporated in FAS 156 to include separately recognized servicing assets as part of the proceeds of a sale in order to simplify the application of the accounting guidance and provide consistency between servicing assets and servicing liabilities obtained in a transfer of financial assets that meet the requirements for sale accounting. These modifications have also been adopted for statutory accounting, with adjustments to statutory accounting illustrations accordingly.

11. Prior to the issuance of FAS 156, separately recognized servicing assets were included as part of retained interests. This issue paper incorporates nonsubstantive revisions to SSAP No. 91, similar to those...
included within FAS 156, to restate the term ‘retained interests’ with ‘interests that continue to be held by a transferor’ and to clarify within paragraph 47 that servicing assets are not considered within the context of this term. (Nonsubstantive revisions to SSAP No. 91 are included as a supplement to this issue paper.)

Subsequent Fair Value Measurement of Servicing Assets and Servicing Liabilities

12. Revisions to FAS 156 permit an entity to choose either an amortization method or fair value measurement method for the subsequent measurement of servicing assets and servicing liabilities. For statutory accounting, it is perceived that this subsequent measurement option hinders the comparability and consistency of financial statements. Although extensive disclosure requirements have been established within FAS 156 to counter the non-comparability created on the face of the financials, such disclosures cannot be considered a substitute for consistent and comparable measurement of similar items for statutory accounting.

13. Existing guidance within SSAP No. 91 requires amortization of servicing assets and servicing liabilities, however, based on the rationale provided below, SSAP No. 91 will be revised to require subsequent fair value measurement of servicing assets and servicing liabilities at each reporting date:

a. SSAP No. 91 already requires an existing fair value consideration each reporting date for a servicing assets/liabilities impairment assessment;

b. SSAP No. 91 already requires disclosure of fair value, if practicable, of recognized servicing assets/liabilities and the method and significant assumptions used to estimate that fair value.

c. SSAP No. 91 nonadmits servicing assets, so positive fluctuations in fair value would not impact earnings;

d. Fair value is the most appropriate measurement method for servicing assets/liabilities as it illustrates the value of the asset or obligation at the financial statement reporting date;

e. There are no identified insurance industry specific characteristics of servicing assets/liabilities that would justify continued reporting of servicing assets/liabilities in a manner that does not represent the fair value of the asset or obligation at the financial statement reporting date.

f. The FASB rationale permitting entities the option to continue using amortized cost, versus a fair value measurement, was based on some entities using non-derivative financial instruments to offset risks inherent in the servicing assets/liabilities (thus, avoiding volatility from the use of derivatives), and some entities considering servicing assets/liabilities to be contracts for services and not financial instruments. For these situations, subsequent measurement of servicing assets/liabilities at fair value would result in a new source of income statement volatility, which is viewed as not representationally faithful of their performance. Although this rationale was considered, for statutory accounting the recognition and measurement of assets and liabilities is a more relevant factor in assessing an insurer’s financial position. By utilizing fair value, the insurer’s financial position is more appropriately stated.

14. Pursuant to the revisions to require subsequent fair value measurement of servicing assets and servicing liabilities, corresponding disclosure requirements will adequately document the valuation methods and models and the fair value impact caused by input and assumption changes within such models and methods. These revisions will not alter the existing guidance within paragraph 49 of SSAP No. 91 regarding instances in which it is not practicable to estimate fair value.
If It Is Not Practicable to Estimate Fair Values

49. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

b. The amount that would be recognized in accordance with SSAP No. 5.

Servicing Assets and Servicing Liabilities from Securitizations

15. This issue paper confirms adoption of guidance previously included within FAS 140, and revised within FAS 156, that requires separate recognition of servicing assets and servicing liabilities resulting from a transfer of financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities. This guidance was previously adopted from FAS 140 and noted in paragraph 11 of SSAP No. 91: (bolded for emphasis)

11. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. ..

16. The guidance regarding servicing assets and servicing liabilities from such securitizations within FAS 140, revised in FAS 156, included caveats regarding when servicing assets and servicing liabilities could be recognized in accordance with such securitizations. As these limitations were determined through the classification status of the resulting securities (held-for-maturity, available-for-sale, and trading) prescribed by FAS 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115), which was previously rejected for statutory accounting, the caveats for the guaranteed mortgage securitizations were not originally incorporated into SSAP No. 91 for statutory accounting. To clarify the appropriate recognition of servicing assets and servicing liabilities for such securitizations, revisions have been incorporated to mirror the language including within FAS 156, with the exclusion of any limitation imposed by the debt security classification of the resulting securities. (Per FAS 156, securities resulting from such securitizations that are classified as available-for-sale or trading pursuant to FAS 115 should be recognized as a servicing asset or servicing liability. Entities that classify such securities as held-to-maturity are given an option to recognize them as servicing assets or servicing liabilities or report the servicing assets or servicing liabilities with the asset being serviced. FAS 156 was revised from FAS 140 in which entities with held-to-maturity securities were prohibited from recognizing these retained securities as servicing assets or servicing liabilities. )

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

17. Statutory accounting for the transfers, servicing of financial assets and extinguishments of liabilities is provided in SSAP No. 91. The accounting guidance in SSAP No. 91 was established from the guidance provided in SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18), SSAP No. 33—Securitization (SSAP No. 33) and SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (SSAP No. 45), and was expanded to include issues addressed in FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140).
18. SSAP No. 91 adopted FAS 140 with the following modifications:
   
a. Servicing rights assets are nonadmitted;

b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. As statutory financial statements are prepared on a legal entity basis, special-purpose entities shall not be consolidated in a reporting entity’s statutory financial statements;

d. Leases shall be accounted for in accordance with SSAP No. 22—Leases;

e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and

f. The concepts of revolving-period securitizations, banker’s acceptances and risk participations in banker’s acceptances are not applicable for statutory accounting purposes.

g. This statement does not adopt the accounting for collateral as outlined in FAS 140.

19. With the adoption of this issue paper, SSAP No. 91 will be substantively revised (referred as SSAP No. 91R – Jan. 2009) to reflect the adoption of FAS 156 with the following modifications:

   a. This statement adopts provisions within FAS 156 requiring an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:

      i. A transfer of the servicer’s financial assets that meets the requirements for sale accounting.

      ii. A transfer of the servicer’s financial assets to a qualifying special-purpose entity in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities. (This rejects FAS 156 language that considers the classification of such securities (held-to-maturity, available-for-sale or trading) prescribed in accordance with FAS 115.)

      iii. An acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer. (This rejects FAS 156 language pertaining to consolidated affiliates.)

   b. This statement adopts provisions within FAS 156 requiring all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable.

   c. This statement rejects provisions provided within FAS 156 allowing entities to choose either an amortization method or a fair value measurement method for subsequent measurement of separately recognized servicing assets and servicing liabilities. In accordance with this issue paper, subsequent measurement of such items should be completed in accordance with a fair value measurement method. If fair value is not practicable to determine, the guidance in paragraph 49 of SSAP No. 91 should be followed.
d. This statement rejects FAS 156 provisions permitting a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under FAS 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity’s exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value. (FAS 115 was rejected for statutory accounting, thus these classifications are not relevant to statutory accounting and do not impact the measurement of securities.)

e. This statement adopts provisions within FAS 156 requiring separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

Generally Accepted Accounting Principles

20. This issue paper adopts with modifications guidance included within FAS 156.

21. FAS 156 nullifies EITF Issue No. 88-11, Allocation of Recorded Investment When a Loan or Part of a Loan is Sold (EITF No. 88-11). This issue was adopted within SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18) and SSAP No. 91. EITF No. 88-11 addressed how a recorded investment in a loan should be allocated between the portion of the loan sold and the portion retained. Per the consensus issued within this statement, such allocation should be based on the relative fair value on the date the loan was acquired, adjusted for payments and other activity from the date of sale. Similar to GAAP’s nullification of this consensus, this item is no longer relevant for statutory accounting.

22. With the exception of the nullification of EITF 88-11, there is no other impact to the GAAP guidance referenced within paragraphs 94 and 95 of SSAP No. 91:

94. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used in Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force (EITF) No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB EITF No. 88-18, Sales of Future Revenues, FASB EITF No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB EITF No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB EITF No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments.


RELEVANT LITERATURE:

Statutory Accounting

- SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- INT 99-07: EITF 97-3: Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125
INT 99-08: EITF 97-6: 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
INT 99-14: EITF 96-16: Debtor’s Accounting for a Modification or Exchange of Debt Instruments
INT 99-22: EITF 98-8: Accounting for Transfers of Investments That Are in Substance Real Estate
INT 00-11: EITF 98-15: Structured Notes Acquired for a Specified Investment Strategy
INT 01-31: Assets Pledged as Collateral
INT 03-05: EITF 01-7: Creditor’s Accounting for a Modification or Exchange of Debt Instruments
INT 04-21: EITF 02-9: Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold

Generally Accepted Accounting Principles
- FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position
- FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement
- FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues
- FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios
- FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement
- FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights
- FASB Emerging Issues Task Force No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments

STATE REGULATIONS:
- No additional guidance obtained from state statutes or regulations.
Issue Paper No. 134—Supplement of Nonsubstantive Revisions

1. As noted within paragraph 4, this issue paper adopts nonsubstantive revisions to SSAP No. 91R regarding the definition and terminology for ‘interests that continue to be held by the transferor’. The following paragraphs illustrate the nonsubstantive revisions that will be made in accordance with this change in terminology or additional nonsubstantive revisions incorporated within SSAP No. 91R:

7. Upon completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 5), the transferor (seller) shall:

**Retained Interests/Interests That Continue to be Held by a Transferor**

47. Other interests in transferred assets, those that are not part of the proceeds of the transfer, are retained interests/interests that continue to be held by a transferor over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests/interests that continue to be held by a transferor, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests/interests that continue to be held by a transferor include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 46.

48. If the retained interests/interests that continue to be held by a transferor are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests/interests that continue to be held by a transferor most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests/interests that continue to be held by a transferor. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.

Disclosures

88. A reporting entity shall disclose the following:

d. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the retained interests/interests that continue to be held by a transferor, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary to the Statements of Statutory Accounting Principles); and

ii. The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests/interests that continue to be held by a transferor) and the gain or loss from sale of financial assets in securitizations;

iii. The key assumptions used in measuring the fair value of retained interests/interests that continue to be held by a transferor at the time of...
securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and

iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained.)

g. If the entity has retained interests that continue to be held by a transferor in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those retained interests that continue to be held by a transferor, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary to the Statements of Statutory Accounting Principles);

ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);

iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii. above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and

iv. For the securitized assets and any other financial assets that the entity manages together with the retained interests that continue to be held by a transferor:\n
(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;

(b) Delinquencies at the end of the period; and

(c) Credit losses, net of recoveries, during the period.

v. Disclosure of average balances during the period is encouraged, but not required.

2. Additionally, the illustration ‘Recording Transfers of Partial Interests’ will have nonsubstantive revisions as the terms ‘one-tenth interest retained’ will be revised to reflect ‘One-tenth interest that continues to be held by the transferor’. Replication of this illustration in this Issue Paper for these terminology revisions was not considered necessary.

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1 Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.
EXHIBIT A - GLOSSARY

Asset Securitization

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial Interest Holder ("BIH")

Holder of beneficial interests

Cleanup Call

An option held by the servicer, which may be the transferor, to purchase transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome in relation to the benefits or servicing.

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative Financial Instrument

A derivative instrument (as defined in SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions) that is a financial instrument (refer to SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments, paragraph 2).

Embedded Call (See paragraphs 40 and 42)

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.
Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Financial Liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Guaranteed Mortgage Securitization

A securitization of mortgage loans which includes a substantive guarantee by a third party.

Interests that continue to be held by a transferor

Other interests in transferred assets, those that are not part of the proceeds of the transfer, over which the transferor has not relinquished control. Includes securities backed by the transferred assets, undivided interests, and cash reserve accounts and residual interests in securitization trusts.

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Residual

Residuals are a class of retained or purchased beneficial interests that have rights to the last cash flows from the pool of securitized assets and are not rated by a Nationally Recognized Statistical Rating Organization (NRSRO). Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss.

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.
Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided Interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unrestricted Collateral

Securities received that may be sold or repledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.

Unilateral Ability (See paragraphs 40 and 41)

A capacity for action not dependent on the actions (or failure to act) of any other party.
Issue Paper No. 135

Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

STATUS:
Finalized Oct. 18, 2010

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. In November 2002, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 45: Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB interpretation No. 34 (FIN 45) to elaborate on the disclosures required for obligations issued under certain guarantees and to clarify that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. In November 2005, the FASB issued FASB Staff Position FIN 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or its Owners (FSP FIN 45-3). This FSP modified the scope of FIN 45 to expressly include guarantees granted to a business or owner guarantying that the revenue of the business (or a specific portion of the business) for a specified period will be at least a specified amount within the scope of FIN 45. For purposes of this Issue Paper, the Statutory Accounting Principles Working Group will consider FIN 45, as modified by FSP FIN 45-3 for statutory accounting.

2. Current statutory accounting guidance for guarantees is limited to the disclosure requirements in paragraph 16 of SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5). In accordance with this existing guidance, guarantees shall be disclosed in the financial statements even though the possibility of loss may be remote and disclosures are required regarding the indebtedness of others. These disclosure requirements were incorporated through the adoption of FASB Interpretation No. 34—Disclosure of Indirect Guarantees on Indebtedness of Others, An Interpretation of FASB Statement No. 5 (FIN 34) and FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161 (FSP FAS 133-1 and FIN 45-4). With the issuance of FIN 45, FASB superseded FIN 34.

3. The purpose of this issue paper is to update statutory accounting principles for guarantees. The proposed result will be adoption, with modification, of guidance from FIN 45, and the incorporation of substantive revisions to SSAP No. 5 and nonsubstantive revisions to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25). In accordance with the adoption, with modification, of FIN 45, guarantors will be required to recognize, at the inception of the guarantee, a liability for the obligations it has undertaken in issuing the guarantee, including its obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur. The adoption, with modification, of FIN 45 will also require the following disclosures by guarantors: (a) the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee; (b) the maximum potential amount of future payments under the guarantee; (c) the carrying amount of the liability, if any, for the guarantor’s obligations under the guarantee; and (d)
the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantee.

SUMMARY CONCLUSION

4. This issue paper adopts, with modification, guidance within FIN 45, as modified by FSP FIN 45-3, indicating that at the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee, which generally equals the fair value of the guarantee at its inception. This issue paper also adopts the disclosures within the modified FIN 45 to ensure proper information is provided within the financial statements regarding guarantees, even if the likelihood of having to make payments under a guarantee is remote.

DISCUSSION

5. The FASB issued FIN 45 as a result of observing differing interpretations about the disclosures required of guarantors under FASB Statement No. 5, Accounting for Contingencies (FAS 5) and about the need for a guarantor to recognize an initial liability for its obligation under a guarantee. As some constituents believed that FAS 5 prohibited a guarantor from initially recognizing a liability for a guarantee issued unless it is probable that payments will be required under that guarantee, the issuance of FIN 45 clarified the requirements of FAS 5 relating to the guarantor’s accounting for and disclosures of certain guarantees issued.

6. FIN 45 clarified that a guarantor is required to disclose (a) the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee; (b) the maximum potential amount of future payments under the guarantee; (c) the carrying amount of the liability, if any, for the guarantor’s obligations under the guarantee; and (d) the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantee. For product warranties, instead of disclosing the maximum potential amount of future payments under the guarantee, a guarantor is required to disclose its accounting policy and methodology used in determining its liability for product warranties as well as a tabular reconciliation of the changes in the guarantor’s product warranty liability for the reporting period. In issuing FIN 45, the FASB noted that disclosures under the prior practice generally included only the nature and amount of guarantees, but did not provide the same level of useful information as required by FIN 45.

7. FIN 45 also clarified that a guarantor is required to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, including its ongoing obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur. The objective of the initial measurement of that liability is the fair value of the guarantee at its inception. Before the issuance of FIN 45, the FASB believed that many entities may not be recognizing a liability for a guarantee because the recognition requirements in FAS 5 (pertaining to loss contingencies) have not been met at the inception of the guarantee and the premium for the guarantee was not separately identified because it was embedded in purchase or sales agreements, service contracts, joint venture agreements, or other commercial agreements.

8. In issuing FIN 45, and requiring recognition of a liability for the obligations undertaken upon issuing a guarantee, the FASB believed that it resulted with a more representationally faithful depiction of the guarantor’s assets and liabilities. When a guarantee is issued without a separately identified premium in conjunction with another transaction, the gain or loss recognized on that other transaction would be misstated if the guarantor fails to recognize a liability for the guarantee. For example, if a seller-guarantor issues to its customer’s bank a guarantee of the customer’s loan to facilitate the customer’s obtaining funds to pay the seller for the assets being purchased, the failure to recognize a liability for the issuance of the guarantee overstates the profit on the sale. In those circumstances, the recognition of the liability for...
the guarantee results in a more representationally faithful depiction of the seller-guarantor’s liabilities and results of operations. The initial recognition and initial measurement requirements within FIN 45 were expected to affect primarily the accounting for multiple-element transactions that include issuance of a guarantee by one party to the other. Additionally, the FASB concluded that the disclosures required by FIN 45 improve the transparency of the financial statement information about the guarantor’s obligations and liquidity risks related to guarantees issued.

9. The FASB concluded that the disclosures and initial recognition of guarantees required by FIN 45 complies with the *FASB Concept Statement No. 1, Objectives of Financial Reporting by Business Enterprises*, as financial reporting should provide information to help users assess the amounts, timing, and uncertainty of the guarantor’s prospective net cash flows. Furthermore, the FASB concluded that recognition of a liability at the inception of a guarantee is consistent with the definition of a liability in *FASB Concepts Statement No. 6, Elements of Financial Statements*.

10. In November 2005, the FASB issued FASB Staff Position FIN 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or its Owners* (FSP FIN 45-3). This FSP modified the scope of FIN 45 to expressly include guarantees granted to a business or owner guaranteeing that the revenue of the business (or a specific portion of the business) for a specified period will be at least a specified amount within the scope of FIN 45. In making this decision, the FASB concluded that a minimum revenue guarantee granted to a business or its owners meets the characteristics in paragraph 3(a) of FIN 45 because the guarantee’s underlying (business gross revenues) is related to an asset or equity security of the guaranteed party. The FASB also clarified that the five examples included within paragraph 3(a) do not constitute an all-inclusive listing of the contracts that would meet the scope provisions of FIN 45.

11. In considering FIN 45, as modified for FIN 45-3, for statutory accounting purposes, the adoption of the guidance in FIN 45 is consistent with the conservatism concept stated within the preamble: “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.” In accordance with this concept, it is presumed that there must be a compelling reason to have statutory accounting principles that are less conservative than GAAP. In reviewing this issue, staff was unable to identify any such compelling reasons, however, until FIN 45 is adopted for statutory accounting, it will result with less-conservative financial statements for statutory accounting.

12. It is anticipated that comments will be received indicating that the initial recognition of a liability will not represent a “probable” occurrence, and thus will not meet the definition of a liability per SSAP No. 5, paragraph 3. Similar to the FASB’s response to such comments, the probability of performance under the guarantee will affect the measurement of the liability at inception, but the probability of performance does not change the fact that a liability has been created upon the issuance of the guarantee and should be reflected in the financial statements. The recognition of a liability for a guarantee is a valid under SSAP No. 5 because it clarifies that the definition of a liability within SSAP No. 5 should not be understood as prohibiting the recognition of a liability for the obligations undertaken in issuing a guarantee, even if the likelihood of the event that would trigger performance under the guarantee is less than remote.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

13. Statutory accounting guidance regarding guarantees is included within SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5). The guidance for guarantees is limited to disclosures within paragraph 16. The current disclosure requirements, which require disclosure of guarantees even if the possibility of loss is remote and disclosures on guarantees on the indebtedness of others, were adopted from FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, An Interpretation of FASB Statement No. 5 and FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161.

16. 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.

   a. For guarantees on indebtedness of others, disclosure shall include the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, the events and circumstances that would require the guarantor to perform under the guarantee, and the current status as of the reporting date of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

14. With the adoption of this issue paper, SSAP No. 5 will reflect the adoption, with modification, of FIN 45, as modified by FSP FIN 45-3. The statutory modifications require an initial liability recognition for guarantees issued as part of intercompany or related party transactions, require assessment and recognition of non-contingent guarantee obligations after recognition and settlement of a contingent obligation and revise the GAAP guidance to reflect statutory accounting terms and restrictions. (For example, a GAAP exclusion for capital leases will not be incorporated within SSAP No. 5 as the concept of capital leases has previously been rejected for statutory accounting.) Although FIN 45 does not require initial liability recognition for the following guarantees: 1) guarantee issued either between parents and their subsidiaries or between corporations under common control; 2) parent’s guarantee of its subsidiary debt to a third party, and 3) subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent, this Issue Paper requires an initial liability recognition under statutory accounting for such guarantees. For these instances, and other intercompany and related party guarantees, this Issue Paper requires that an initial liability must be recognized for the guarantee unless the guarantee is considered “unlimited” or is a guarantee made to/or on behalf of a wholly-owned subsidiary. (An example of an intercompany “unlimited” guarantee would be a guarantee issued in response to a rating agency’s requirement to provide a commitment to support.) In instances in which an “unlimited” guarantee exists or a guarantee has been made to/or on behalf of a wholly-owned subsidiary, this Issue Paper would require disclosure, pursuant to the disclosure requirements adopted from FIN 45. These disclosure requirements include the maximum potential amount of future payments of the guarantee, and if the guarantor is unable to determine the maximum potential, the reasons why this amount cannot be
determined. The adoption of this Issue Paper will also revise the current disclosure requirements, presented within SSAP No. 5, paragraph 16a, regarding guarantees on the indebtedness of others. These disclosure requirements, adopted from FSP FAS 133-1 and FIN 45-4, will be reorganized within SSAP No. 5 and presented in a manner consistent with the modifications incorporated within FIN 45 pursuant to the adoption of this FASB Staff Position.

15. Upon adoption of this Issue Paper, the NAIC will release an updated Statement of Statutory Accounting Principle (SSAP) No. 5 for comment. The SSAP will contain the adopted substantive changes to SSAP No. 5, shown in this Issue Paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted.

16. Guidance is currently included within paragraph 18e of SSAP No. 25—Accounting for and Disclosures About Transactions with Affiliates and Other Related Parties (SSAP No. 25) that requires related party disclosures for guarantees or undertakings that result in a material contingent exposure:

18. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions 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:

   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;

17. This Issue Paper also proposes nonsubstantive revisions to the SSAP No. 25, paragraph 18e guidance to require the FIN 45 disclosure requirements for related party guarantees, including those issued between parents and their subsidiaries or between corporations under common control and situations in which a parent guarantees its subsidiary’s debt to a third party or the subsidiary has guaranteed debt owed to a third party by either its parent or another subsidiary of that parent.

18. The adoption of FIN 45 or FSP FIN 45-4 will not impact any of the existing statutory interpretations of SSAP No. 5:

   a. INT 01-31: Assets Pledged as Collateral (INT 01-31) – This interpretation addresses the accounting issues on whether assets pledged as collateral under specific situations should be considered admitted assets. The consensus reached for INT 01-31 is that the collateral would continue to be recorded as an admitted asset until the reporting entity has committed a contract default that has not been cured in accordance with the contract provisions. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer should only record an admitted asset for the amount of collateral that it can redeem.

   b. INT 01-32: EITF 01-10: Accounting for the Impact of the Terrorist Attacks of September 11, 2001 (INT 01-32) – This interpretation incorporated specific disclosures for losses and costs incurred as a result of the September 11, 2001 events. On June 2, 2007, these disclosure requirements were deemed no longer useful by the Statutory Accounting Principles Working Group.
c. **INT 03-07: EITF 00-19: Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, A Company’s Own Stock** (INT 03-07) – This interpretation rejected the guidance in EITF 00-19 as not applicable to statutory accounting.

d. **INT 04-05: Clarification of SSAP No. 5 Guidance on When a Judgment is Deemed Rendered** (INT 04-05) – The consensus reached under INT 04-05 incorporated guidance within SSAP No. 5 that a judgment is considered “rendered” when a court enters a verdict, notwithstanding the entity’s ability to file post trial motions and to appeal.

19. The Form A summary of this issue also identified **INT 01-03: Assets Pledged as Collateral or Restricted for the Benefit of a Related Party** (INT 01-03) as a possible interpretation that may be affected with FIN 45. The consensus under INT 01-03 indicates that if an asset of an insurance entity is pledged or otherwise restricted by a related party, the assets are not under the exclusive control of the insurance entity, and should not be recognized on the balance sheet. As this interpretation specifically addresses the treatment of the pledged asset, and not the recording or disclosure of a guarantee, it is anticipated that no revisions will be necessary to this interpretation with the adoption of this Issue Paper.

**Generally Accepted Accounting Principles**

20. This issue paper adopts, with modifications, guidance included within FIN 45, as modified by FSP FIN 45-3. (Guidance from FSP FAS 133-1 and FIN 45-4 has previously been adopted for statutory accounting. However, the current version of FIN 45, including the revisions from FSP FAS 133-1 and FIN 45-4 are reflected below.)

**FIN 45, as Modified by FSP FIN 45-3 and FSP FIN 45-4:**

**INTRODUCTION**

1. The Board observed differences in interpretation about the disclosures required of issuers of guarantees and about the need for an issuer of a guarantee to recognize an initial liability for its obligations under the guarantee. This Interpretation clarifies the requirements for a guarantor’s accounting for and disclosures of certain guarantees issued and outstanding. This Interpretation also incorporates without reconsideration the guidance in FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, which is being superseded.

**SCOPE**

2. This Interpretation addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. This Interpretation also clarifies the requirements related to the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee. As discussed in paragraph 12, this Interpretation does not specify the subsequent measurement of the guarantor’s recognized liability for either the noncontingent aspect of the guarantee or the contingent aspect of the guarantee. The accounting for the contingent aspect of the guarantee, if it is not accounted for as a derivative under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, is covered by FASB Statement No. 5, Accounting for Contingencies. The provisions in Statement 5 about disclosure of a loss that is reasonably possible are not affected by this Interpretation.

3. Except as provided in paragraphs 6 and 7, the provisions of this Interpretation apply to guarantee contracts that have any of the following characteristics:
Guarantor’s Accounting and Disclosure Requirements for Guarantees

a. Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, provision of services) to the guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party. Thus, for example, the provisions apply to the following:

(1) A financial standby letter of credit, which is an irrevocable undertaking (typically by a financial institution) to guarantee payment of a specified financial obligation

(2) A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party

(3) A guarantee of the market price of the common stock of the guaranteed party

(4) A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity (SPE)

(5) A guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount.

b. Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, provision of services) to the guaranteed party based on another entity’s failure to perform under an obligating agreement (performance guarantees). Thus, for example, the provisions apply to a performance standby letter of credit, which is an irrevocable undertaking by a guarantor to make payments in the event a specified third party fails to perform under a nonfinancial contractual obligation.

c. Indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.

d. Indirect guarantees of the indebtedness of others, as that phrase is used in paragraphs 17 and 18 (and originally in Interpretation 34), even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

4. Commercial letters of credit and other loan commitments, which are commonly thought of as guarantees of funding, are not included in the scope of this Interpretation because those arrangements do not meet any of the four characteristics identified in paragraph 3 above. Similarly, the scope of this Interpretation does not encompass indemnifications or guarantees of an entity’s own future performance (for example, a guarantee that the guarantor will not take a certain future action). It does not include a noncontingent forward contract for which the net settlement can flow from either party to the other party; however, a contingent forward contract may meet one of the characteristics in paragraph 3 and be included in the scope of this Interpretation.

5. Some securitizations and other arrangements involve the subordination of the rights of some investors (or creditors) to the rights of others, in which case, for example, the investors in one (subordinated) class or tranche of an entity’s securities might not receive any cash flows until the investors in another (priority) class or tranche are fully paid. Because that type of subordination provides credit protection by the subordinated
investors, those subordination arrangements are commonly thought of as guarantees issued by the subordinated investors. Such subordination arrangements do not meet the characteristic-based scope provisions in paragraph 3 and, thus, are not included in the scope of this Interpretation.

Scope Exceptions from the Entire Interpretation

6. Notwithstanding the characteristic-based scope provisions in paragraph 3, this Interpretation does not apply to the following guarantee contracts:
   
a. A guarantee or an indemnification that is excluded from the scope of Statement 5 under paragraph 7 of that Statement.

b. A lessee's guarantee of the residual value of the leased property at the expiration of the lease term, if the lessee (guarantor) accounts for the lease as a capital lease under FASB Statement No. 13, Accounting for Leases.

c. A contract that meets the characteristics in paragraph 3(a) but is accounted for as contingent rent under Statement 13.

d. A guarantee (or an indemnification) that is issued by either an insurance company or a reinsurance company and accounted for under FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, or No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (including guarantees embedded in either insurance contracts or investment contracts).

e. A contract that meets the characteristics in paragraph 3(a) but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party. (Vendor rebates based on the volume of purchases by the buyer would not meet the characteristics in paragraph 3(a) because the underlying relates to an asset of the seller, not the buyer who receives the rebates.)

f. A guarantee (or an indemnification) whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction.

g. A registration payment arrangement within the scope of FSP EITF 00-19-2, "Accounting for Registration Payment Arrangements."

h. A guarantee that is accounted for as a credit derivative instrument at fair value under Statement 133, as described in paragraph 44DD of Statement 133.

Scope Exceptions from Only the Initial Recognition and Initial Measurement Provisions

7. The following types of guarantees are not subject to the initial recognition and initial measurement provisions of this Interpretation but are subject to its disclosure requirements:

a. A guarantee, other than a credit derivative as described in paragraph 44DD of Statement 133, that is accounted for as a derivative instrument at fair value under Statement 133.
b. A guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party. Thus, the initial recognition and initial measurement provisions of this Interpretation do not apply to product warranties issued by the guarantor, regardless of whether the guarantor is required to make payment in services or cash, including separately priced extended warranty or product maintenance contracts that are addressed in FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts.

c. A guarantee issued in a business combination that represents contingent consideration (as addressed in FASB Statement No. 141, Business Combinations).

d. A guarantee for which the guarantor’s obligation would be reported as an equity item (rather than a liability) under generally accepted accounting principles (GAAP).

e. A guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligor (that is, principal debtor) under the original lease, as discussed in paragraph 38 of Statement 13, as amended by FASB Statement No. 145, Recission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. This exception shall not be applied by analogy to secondary obligations that are not accounted for under paragraph 38 of Statement 13. (The disclosure requirements of this Interpretation do apply to the original lessee that has become secondarily liable for the lease payments.)

f. A guarantee issued either between parents and their subsidiaries or between corporations under common control.

g. A parent’s guarantee of its subsidiary’s debt to a third party (whether the parent is a corporation or an individual).

h. A subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

INTERPRETATION

Initial Recognition and Initial Measurement of the Liability for a Guarantor’s Obligations

8. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect).

9. Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur, the provisions of paragraphs 8–12 of Statement 5 regarding the guarantor’s contingent obligation under a guarantee should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 10, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.
a. When a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor as a practical expedient.

b. When a guarantee is issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset or entering into an operating lease), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party as a practical expedient.

c. When a guarantee is issued as a contribution to an unrelated party, the liability recognized at the inception of the guarantee should be measured at its fair value, consistent with the requirement to measure the contribution made at fair value, as prescribed in paragraph 18 of FASB Statement No. 116, Accounting for Contributions Received and Contributions Made. For example, a community foundation may have a loan guarantee program to assist not-for-profit organizations in obtaining bank financing at a reasonable cost. Under that program, the community foundation may issue a guarantee of a not-for-profit organization's bank debt. Upon the issuance of the guarantee, the community foundation would recognize a liability for the fair value of that guarantee. The issuance of that guarantee would not be considered merely a conditional promise to give under paragraph 22 of Statement 116 because, upon the issuance of the guarantee, the not-for-profit organization will have received the gift of the community foundation's credit support, which enables the not-for-profit organization to obtain a lower interest rate on its borrowing.

10. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under Statement 5 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount that satisfies the fair value objective as discussed in paragraph 9 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8 of Statement 5. For many guarantors, it would be unusual for the contingent liability amount under (b) above to exceed the amount that satisfies the fair value objective under (a) above at the inception of the guarantee.

11. This Interpretation does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued, as illustrated by the following examples:

a. If the guarantee were issued in a standalone transaction for a premium, the offsetting entry would be consideration received (such as cash or a receivable).

b. If the guarantee were issued in conjunction with the sale of assets, a product, or a business, the overall proceeds (such as the cash received or receivable) would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from the sale. That allocation would affect the calculation of the gain or loss on the sale transaction.

c. If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.

d. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry (representing a payment in kind made by the lessee when entering into the operating lease) would be reflected...
as prepaid rent, which would be accounted for under paragraph 15 of Statement 13.

e. If a guarantee were issued to an unrelated party for no consideration on a standalone basis (that is, not in conjunction with any other transaction or ownership relationship), the offsetting entry would be to expense.

12. This Interpretation does not describe in detail how the guarantor's liability for its obligations under the guarantee would be measured subsequent to its initial recognition. The liability that the guarantor initially recognized under paragraph 9 consistent with the fair value objective discussed in that paragraph would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee. Depending on the nature of the guarantee, the guarantor’s release from risk has typically been recognized over the term of the guarantee (a) only upon either expiration or settlement of the guarantee, (b) by a systematic and rational amortization method, or (c) as the fair value of the guarantee changes (as is done, for example, for guarantees accounted for as derivatives). The discussion in this paragraph about how the guarantor typically reduces the liability that it initially recognized does not encompass the recognition and subsequent adjustment of the contingent liability recognized under Statement 5 related to the contingent loss for the guarantee.

Disclosures about a Guarantor's Obligations under Guarantees

13. A guarantor shall disclose the following information about each guarantee, or each group of similar guarantees, even if the likelihood of the guarantor’s having to make any payments under the guarantee is remote, except as provided in paragraph 14 with respect to the disclosure specified in paragraph 13(b):

a. The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, the events or circumstances that would require the guarantor to perform under the guarantee and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

b. The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (which are addressed under (d) below). If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact shall be disclosed. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor shall disclose the reasons why it cannot estimate the maximum potential amount. (Refer to the following paragraph for an exception to the requirements of this subparagraph.)

c. The current carrying amount of the liability, if any, for the guarantor’s obligations under the guarantee (including the amount, if any, recognized under paragraph 8 of Statement 5), regardless of whether the guarantee is freestanding or embedded in another contract.

d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence
of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The guarantor shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

14. For product warranties and other guarantee contracts that are excluded from the initial recognition and initial measurement requirements of this Interpretation pursuant to paragraph 7(b) (collectively referred to as product warranties), a guarantor is not required to disclose the maximum potential amount of future payments specified in paragraph 13(b) above. Instead, the guarantor is required to disclose for those product warranties the following information:

a. The guarantor’s accounting policy and methodology used in determining its liability for product warranties (including any liability [such as deferred revenue] associated with extended warranties).

b. A tabular reconciliation of the changes in the guarantor’s aggregate product warranty liability for the reporting period. That reconciliation should present the beginning balance of the aggregate product warranty liability, the aggregate reductions in that liability for payments made (in cash or in kind) under the warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, the aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates), and the ending balance of the aggregate product warranty liability.

15. The disclosures required by this Interpretation do not eliminate or affect the requirement in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, as amended by FASB Statement No. 126, Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, that certain entities disclose the fair value of their financial guarantees issued.

16. Some guarantees are issued to benefit entities that meet the definition of a related party in paragraph 24(f) of FASB Statement No. 57, Related Party Disclosures, such as joint ventures, equity method investees, and certain entities for which the controlling financial interest cannot be assessed by analyzing voting interests. In those cases, the disclosures required by this Interpretation are incremental to the disclosures required by Statement 57.

Indirect Guarantees of Indebtedness of Others Encompassed by Paragraph 12 of Statement 5

17. An indirect guarantee of the indebtedness of another arises under an agreement that obligates one entity to transfer funds to a second entity upon the occurrence of specified events, under conditions whereby (a) the funds become legally available to creditors of the second entity and (b) those creditors may enforce the second entity’s claims against the first entity under the agreement. Examples of indirect guarantees include agreements to advance funds if a second entity’s net income, coverage of fixed charges, or working capital falls below a specified minimum.

18. The term guarantees of indebtedness of others in paragraph 12 of Statement 5 includes indirect guarantees of indebtedness of others as described in paragraph 17 of this Interpretation.

RESCISSION OF INTERPRETATION 34

19. Interpretation 34 is superseded by this Interpretation.
EFFECTIVE DATE AND TRANSITION

20. The initial recognition and initial measurement provisions in paragraphs 9 and 10 shall be applied only on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The guarantor's previous accounting for guarantees issued prior to the date of this Interpretation's initial application shall not be revised or restated to reflect the effect of the recognition and measurement provisions of the Interpretation.

21. The disclosure requirements in paragraphs 13–16 are effective for financial statements of interim or annual periods ending after December 15, 2002. The guidance on indirect guarantees of the indebtedness of others in paragraph 18 continues to apply to financial statements for fiscal years ending after June 15, 1981.

21. FIN 45 supersedes FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, An Interpretation of FASB Statement No. 5 (FIN 34). FIN 34 had previously been adopted within SSAP No. 5 and resulted with disclosure requirements for guarantees, even if the possibility of payment under the guarantee was remote. The guidance in FIN 45 has incorporated more conservative accounting and disclosure requirements for guarantees than FIN 34.

22. The NAIC Statutory Accounting Principles Working Group previously considered FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161 (FSP FAS 133-1 and FIN 45-4), and adopted revisions to SSAP No. 5 to incorporate the revised disclosures within paragraph 13a of FIN 45 as modified by FSP FAS 133-1 and FIN 45-4. (The revisions to FIN 45 from FSP FAS 133-1 and FIN 45-4 are reflected within the FIN 45 guidance included in paragraph 20 of this Issue paper.)

RELEVANT LITERATURE:

Statutory Accounting
– SSAP No. 5—Liabilities, Contingencies and Impairments of Assets

Generally Accepted Accounting Principles
– FASB Statement No. 5, Accounting for Contingencies
– FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan
– FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements
– FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5
– FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, 107 and rescission of FASB Interpretation No. 35
– FASB Interpretation No. 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Grated to a Business or Owner
– FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees, an Amendment of FASB Statement No. 133 and FASB Interpretation No. 45, and Clarification of the Effective Date of FASB Statement No. 161.
– Accounting Principles Board Opinions No. 12, Omnibus Opinion—1967, paragraphs 2 and 3

State Regulations
No additional guidance obtained from state statutes or regulations.
Appendix A: Substantive Revisions to SSAP No. 5 Adopting, with Modification, FIN 45

SCOPE OF STATEMENT

1. This statement defines and establishes statutory accounting principles for liabilities, contingencies and impairments of assets.

SUMMARY CONCLUSION

Liabilities

2. A liability is 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 a past transaction(s) or event(s).

3. 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., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity's financial statements when incurred.

4. 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

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

   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 probable;
   c. Remote—The chance of the future event or events occurring is slight.

6. 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).

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1. FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, 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, paragraph 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.
7. 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.

8. 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., a known impairment of a bond even though the VOS manual has not recognized the impairment).

9. Additionally, in instances where a judgment, assessment or fine has been rendered against a reporting entity, there is a presumption that the criteria in paragraph 7 a. and 7 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.

10. When condition 7 a. above is met with respect to a particular loss contingency, and the reasonable estimate of the loss is a range, which meets condition 7 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, 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.

11. The use of 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.

Gain Contingencies

12. A gain is defined as an increase in surplus 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. The definition of a gain 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.
13. A gain contingency is 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.

Guarantees

14. A guarantee contract is a contract that contingently requires the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on changes in the underlying that is related to an asset, a liability, or an equity security of the guaranteed party. Commercial letters of credit and loan commitments, by definition, are not considered guarantee contracts. Also excluded from the definition are indemnifications or guarantees of an entity’s own performance, subordination arrangements or a noncontingent forward contract. This definition could include contingent forward contracts if the characteristics of this paragraph are met.

15. The following guarantee contracts are not subject to the guidance in paragraphs 18-23 and paragraphs 26-29:
   a. Guarantees already excluded from the scope of SSAP No. 5R;
   b. Guarantee contracts accounted for as contingent rent;
   c. Insurance contract guarantees, including guarantees embedded in deposit-type contracts;
   d. Contracts that provide for payments that constitute a vendor rebate by the guarantor based on either the sales revenue or the number of units sold by the guaranteed party;
   e. A guarantee or indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee’s underlying or recognize in earnings the profit from that sale transaction;
   f. Registration payment arrangements; and
   g. A guarantee that is accounted for as a credit derivative instrument at fair value under SSAP No. 86, as described in paragraph 53e of SSAP No. 86.

16. The following types of guarantees are exempted from the initial liability recognition in paragraphs 18-23, but are subject to the to the disclosure requirements in paragraphs 26-29:
   a. Guarantee that is accounted for as a derivative instrument, other than credit derivatives within SSAP No. 86;
   b. Guarantee for which the underlying is related to the performance of nonfinancial assets that are owned by the guaranteed party, including product warranties;
c. Guarantee issued in a business combination that represents contingent consideration;
d. Guarantee in which the guarantor’s obligation would be reported as an equity item;
e. Guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligator; and
f. Guarantees (as defined in paragraph 14) made to/or on behalf of a wholly-owned subsidiary.
g. Intercompany and related party guarantees that are considered “unlimited” (e.g., typically in response to a rating agency’s requirement to provide a commitment to support).

17. With the exception of the provision for guarantees made to/or on behalf of a wholly-owned subsidiaries in paragraph 16f and “unlimited” guarantees in 16g, this guidance does not exclude guarantees issued as intercompany transactions or between related parties from the initial liability recognition requirement. Thus, unless the guarantee is provided on behalf of a wholly-owned subsidiary or considered “unlimited,” guarantees issued between the following parties are subject to the initial recognition and disclosure requirements:
a. Guarantee issued either between parents and their subsidiaries or between corporations under common control;
b. A parent’s guarantee of its subsidiary’s debt to a third party; and
c. A subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

18. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 20, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.

19. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect). Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering event occurs, the provisions of paragraph 7 should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee.

20. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under paragraph 7 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount the satisfies the fair value objective as discussed in paragraph 18 or (b) the contingent liability amount.

2 As practical expedients, when a guarantee is issued in a standalone arm’s-length transaction, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. When a guarantee is issued as part of a transaction with multiple elements, the liability recognized at the inception of the guarantee should be an estimate of the guarantee’s fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm’s-length transaction.
required to be recognized at inception of the guarantee by paragraph 7. For many
guarantors, it would be unusual for the contingent liability under (b) above to exceed the
amount that satisfies the fair value objective at the inception of the guarantee.

21. The offsetting entry pursuant to the liability recognition at the inception of the guarantee
depends on the circumstances in which the guarantee was issued. Examples include:

   a. If the guarantee was issued in a standalone transaction for a premium, the
      offsetting entry would be the consideration received.

   b. If the guarantee was issued in conjunction with the sale of assets, a product, or a
      business, the overall proceeds would be allocated between the consideration
      being remitted to the guarantor for issuing the guarantee and the proceeds from
      that sale. That allocation would affect the calculation of the gain or loss on the
      sale transaction.

   c. If a residual value guarantee were provided by a lessee-guarantor when entering
      into an operating lease, the offsetting entry would be reflected as prepaid rent,
      which would nonadmitted under SSAP No. 29.

   d. If a guarantee were issued to an unrelated or related party for no consideration
      on a standalone basis, the offsetting entry would be to expense.

22. Except for the measurement and recognition of continued guarantee obligations after the
settlement of a contingent guarantee liability described in paragraph 23, this standard
does not describe in detail how the guarantor’s liability for its obligations under the
guarantee would be measured subsequent to initial recognition. The liability that the
guarantor initially recognized in accordance with paragraph 18 would typically be
reduced (as a credit to income) as the guarantor is released from risk under the
guarantee. Depending on the nature of the guarantee, the guarantor's release from risk
has typically been recognized over the term of the guarantee (a) only upon either
expiration or settlement of the guarantee, (b) by a systematic and rational amortization
method, or (c) as the fair value of the guarantee changes (for example, guarantees
accounted for as derivatives). The reduction of liability does not encompass the
recognition and subsequent adjustment of the contingent liability recognized under
paragraph 7 related to the contingent loss for the guarantee. If the guarantor is required
to subsequently recognize a contingent liability for the guarantee, the guarantor shall
eliminate any remaining noncontingent liability for that guarantee and recognize a
contingent liability in accordance with paragraph 7.

23. After recognition and settlement of a contingent guarantee liability in accordance with
paragraph 7, a guarantor shall assess whether remaining potential obligations exist
under the guarantee agreement. If the guarantor still has potential obligations under the
guarantee contract, the guarantor shall recognize the remaining noncontingent guarantee
that represents the current fair value of the potential obligation remaining under the
guarantee agreement. This noncontingent guarantee liability shall be released in
accordance with paragraph 22.

Disclosures

4424. If a loss contingency or impairment of an asset is not recorded because only one of the
conditions 7a. or 7b. 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 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.
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.

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.

For guarantees on indebtedness of others, disclosure shall include the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, the events and circumstances that would require the guarantor to perform under the guarantee, and the current status as of the reporting date of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

A guarantor shall disclose the following information about each guarantee, or each group or similar guarantees (except product warranties addressed in paragraph 29), even if the likelihood of the guarantor's having to make any payments under the guarantee is remote. In addition, the nature of the relationship to the beneficiary of the guarantee or undertaking (affiliated or unaffiliated) shall also be disclosed:

a. The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events and circumstances that would require the guarantor to perform under the guarantee, the ultimate impact to the financial statements (specific financial statement line item) after the settlement of the contract guarantee if action under the guarantee was required (e.g., increase to the investment, dividends to stockholder, etc) and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

b. The potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (which are addressed under (d) below). If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact shall be disclosed. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor shall disclose the reasons why it cannot estimate the maximum potential amount.
c. The current carrying amount of the liability, if any, for the guarantor’s obligations under the guarantee (including the amount, if any, recognized under paragraph 7), regardless of whether the guarantee is freestanding or embedded in another contract.

d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The guarantor shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

28. An aggregate compilation of guarantee obligations shall include the maximum potential of future payments of all guarantees (undiscounted), the current liability (contingent and noncontingent) reported in the financial statements, and the ultimate financial statement impact based on maximum potential payments (undiscounted) if performance under those guarantees had been triggered.

29. As product warranties are excluded from the initial recognition and initial measurement requirements for guarantees, a guarantor is not required to disclose the maximum potential amount of future payments. Instead the guarantor is required to disclose for product warranties the following information:

   a. The guarantor’s accounting policy and methodology used in determining its liability for product warranties (including any liability associated with extended warranties).

   b. A tabular reconciliation of the changes in the guarantor’s aggregate product warranty liability for the reporting period. That reconciliation should present the beginning balance of the aggregate product warranty liability, the aggregate reductions in that liability for payments made (in cash or in kind) under the warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, the aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates), and the ending balance of the aggregate product warranty liability.

47-30. The financial statements shall contain adequate disclosure about the nature of any gain contingency. However, care should be exercised to avoid misleading implications as to the likelihood of realization.

4831. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

4932. This statement adopts FASB Statement No. 5, Accounting for Contingencies (FAS 5), FASB Statement 114, Accounting by Creditors for Impairment of a Loan only as it amends in part FAS 5 and paragraphs 35 and 36 of FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements. FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5 (FIN No. 14) is adopted with the modification to accrue the loss amount as the midpoint of the range rather than the minimum as discussed in paragraph 3 of FIN No. 14.

33. This statement also adopts, with modification, FASB Interpretation No. 45: Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and rescission
Guarantor’s Accounting and Disclosure Requirements for Guarantees

IP No. 135

of FASB Interpretation No. 34 (FIN 45), FASB Interpretation No. 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Owner (FSP FIN 45-3), and FASB Staff Position FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 (FSP FAS 133-1 and FIN 45-4). Statutory Modifications to FIN 45 include initial liability recognition for guarantees issued as part of intercompany or related party transactions, assessment and recognition of non-contingent guarantee obligations after recognition and settlement of a contingent obligation and revise the GAAP guidance to reflect statutory accounting terms and restrictions. Under this issue paper, intercompany and related party guarantees (including guarantees between parents and subsidiaries) should have an initial liability recognition unless the guarantee is considered “unlimited” or is made to/or on behalf of a wholly-owned subsidiary. (An example of an intercompany “unlimited” guarantee would be a guarantee issued in response to a rating agency’s requirement to provide a commitment to support.) In instances in which an “unlimited” guarantee exists or a guarantee has been made to/or on behalf of a wholly-owned subsidiary, this statement requires disclosure, pursuant to the disclosure requirements adopted from FIN 45. The adoption of FIN 45 superseded the previously adopted guidance in FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, 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 and This statement also adopts Accounting Principles Board Opinion No. 12, Omnibus Opinion—1967, paragraphs 2 and 3 with the modification that AVR, IMR and Schedule F Penalty shall be shown gross. Appropriation of retained earnings discussed in paragraph 15 of FAS 5 is addressed in SSAP No. 72—Surplus and Quasi-Reorganizations. This statement adopts FSP FAS 133-1 and FIN 45-5: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161 (FSP FAS 133-1 and FIN 45-4) and requires disclosures by sellers of credit guarantees.

Effective Date and Transition

20.34 This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

21.35 The guidance for guarantees included within paragraphs 14-23 and 27-29 shall be applicable to all guarantees issued or outstanding as of December 31, 2011. Thereafter, disclosure of all guarantees shall be annually reported, with interim reporting required for new guarantees issued, and/or existing guarantees when significant changes are made.

Authoritative Literature

Generally Accepted Accounting Principles

- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan
- FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements
- 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
- FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, 107 and rescission of FASB Interpretation No. 35

- FASB Interpretation No. 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Owner

- FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161.

- Accounting Principles Board Opinions No. 12, Omnibus Opinion—1967, paragraphs 2 and 3
SSAP No. 5R – Appendix A – Disclosure Illustrations

Example illustration for paragraph 27a, including the potential maximum guarantee from paragraph 27b:

| Nature and circumstances of guarantee and key attributes, including date and duration of agreement | Liability recognition of guarantee, (Include amount recognized at inception. If no initial recognition, document exception allowed under SSAP No. 5R) | Ultimate financial statement impact if action under the guarantee is required | Maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. If unable to develop an estimate, this should be specifically noted | Current status of payment or performance risk of guarantee. Also provide additional discussion as warranted |

Example Illustration – Paragraph 28:

1. Aggregate Maximum Potential of Future Payments of All Guarantees (undiscounted) the guarantor could be required to make under guarantees. (This amount should agree to the total amount reported for all guarantees within paragraph 27b (illustrated above), thus it excludes guarantees for which estimates of potential future payment cannot be made.) $ 

2. Current Liability Recognized in F/S:
   a. Noncontingent Liabilities $ 
   b. Contingent Liabilities $ 

3. Ultimate Financial Statement Impact if action under the guarantee is required. (This should equal the total reported in line 1 reflected in the applicable financial statement line items.)
   a. Investments in SCA $ 
   b. Joint Venture $ 
   c. Dividends to Stockholders (capital contribution) $ 
   d. Expense $ 
   e. Other $ 

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Appendix B: Nonsubstantive Revisions to paragraph 18e of SSAP No. 25

18. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions 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:

e. Any guarantees or undertakings, written or otherwise, shall be disclosed in accordance with the requirements of SSAP No. 5R 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;
Statutory Issue Paper No. 137

Transfer of Property and Casualty Reinsurance Agreements in Run-Off

STATUS:
Finalized September 21, 2009

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance relating to property and casualty reinsurance agreements is found in Statement of Statutory Accounting Principle No. 62—Property and Casualty Reinsurance (SSAP No. 62). SSAP No. 62 currently requires that property and casualty reinsurance agreements which transfer insurance risk, but cover liabilities which occurred prior to the effective date of the agreement receive retroactive accounting treatment unless specified exceptions are met.

2. SSAP No. 62 currently allows four specified exceptions to retroactive reinsurance accounting including: structured settlements; novations; termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business; or intercompany reinsurance agreements, provided there is no gain in surplus as a result of the transaction.

3. The purpose of this issue paper is to amend SSAP No. 62 to expand the exceptions to retroactive accounting treatment to include property and casualty reinsurance run-off agreements which meet specified criteria. Reinsurance agreements and retrocession agreements which meet insurance risk transfer requirements and meet the specified criteria will receive specified accounting treatment.

SUMMARY CONCLUSION

4. This issue paper shall amend SSAP No. 62 to insert the following subparagraph e into paragraph 31:

31. The accounting principles for retroactive reinsurance agreements in paragraph 29 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):

   a. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

   b. Novations, (i.e., (i) transactions in which the original direct insurer's obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (ii) transactions in which the original assuming entity's obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;

   c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;

   d. Intercompany reinsurance agreements and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction; or
e. Reinsurance and or retrocession agreements that meet the criteria of property and casualty run-off agreements described in paragraphs 68-71.

5. This issue paper shall amend SSAP No. 62 to insert and renumber the remaining paragraphs of the statement:

Accounting for the Transfer of Property and Casualty Run-off Agreements

68. Property and casualty run-off agreements are reinsurance or retrocession agreements that are intended to transfer essentially all of the risks and benefits of a specific line of business or market segment that is no longer actively marketed by the transferring insurer or reinsurer. A property and casualty run-off agreement is not a novation as the transferring insurer or reinsurer remains primarily liable to the policyholder or ceding entity under the original contracts of insurance or reinsurance. Reinsurance agreements between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) are not eligible for the exception for property and casualty run-off agreements in subparagraph 31.e. of SSAP No. 62.

Criteria

69. The accounting treatment for property and casualty run-off agreements must be approved by the domiciliary regulators of the transferring entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement) and the assuming entity. If the transferring entity and assuming entity are domiciled in the same state, then the regulator of the state where the majority of the transferred liabilities is located shall be asked to approve the accounting treatment. In determining whether to approve an agreement for this accounting treatment, the regulators shall require the following:

a. Assuming Entity Properly Licensed – The entity assuming the run-off agreement must have the appropriate authority or license to write the business being assumed.

b. Limits and Coverages – the reinsurance or retrocession agreement shall provide the same limits and coverages that were afforded in the original insurance or reinsurance agreement.

c. Non-recourse – The reinsurance or retrocession agreement shall not contain any adjustable features or profit share or retrospective rating, and there shall be no recourse (other than normal representations and warranties that would be associated with a purchase and sale agreement) directly or indirectly against the transferring entity.

d. Risk Transfer – the reinsurance or retrocession agreement must meet the requirements of risk transfer as described in this statement.

e. Financial Strength of Reinsurer – the assuming reinsurer shall have a financial strength rating from at least two independent rating agencies (from NAIC acceptable rating agencies) which is equal to or greater than the current ratings of the transferring entity. The lowest financial strength rating received from an NAIC acceptable rating organization rating agency will be used to compare the financial strength ratings of the transferring and assuming entities.

f. Assessments – the assuming reinsurer or retrocessionaire (if required in the original reinsurance contract) shall be financially responsible for any and all assessments, including guaranty fund assessments, that are assessed against the transferring entity related to the insurance business being assumed.
g. Applicable Only to “Run-off” Business – the reinsurance or retrocession agreement shall only cover liabilities relating to a line(s) of business or specific market segments no longer actively marketed by the transferring entity.

h. Non-cancelable Reinsurance – the reinsurance or retrocession agreement shall provide that the reinsurance or retrocessional coverage provided by the proposed agreement cannot be cancelable by either party for any reason. (However, this provision will not override standard contract law and principles and will not prevent any remedies, including rescission or termination that might be available for breach, misrepresentation, etc.)

Statutory Schedules and Exhibits

70. At the inception of the transaction, the transferring entity shall record the consideration paid to the assuming entity as a paid loss. If the consideration paid by the transferring entity is less than the loss reserves transferred, the difference shall be recorded by the ceding entity as a decrease in losses incurred. The assuming entity shall record the consideration received as a negative paid loss. In addition, the transferring entity shall record an increase to ceded reinsurance recoverable for the amount of the transferred reserve. Journal entries illustrating these transactions, including situations in which the transaction includes an unearned premium reserve, are included in Exhibit B of this Statement.

71. The assuming entity will report the business in the same line of business as reported by the original insurer or reinsurer. The assuming entity will report the business at the same level of detail using the appropriate statutory schedules and exhibits.

Disclosures

6. This issue paper amends the disclosures section of SSAP No. 62 to add new paragraph 86 requiring additional disclosures and renumbering subsequent paragraphs:

86. Disclosures for the Transfer of Property and Casualty Run-off Agreements

   a. Disclose if the reporting entity has entered into any agreements which have been approved by their domiciliary regulator and have qualified pursuant to SSAP No. 62, subparagraph 31.e., Accounting for the Transfer of Property and Casualty Run-off Agreements.

   b. If affirmative, provide a description of the agreement and the amount of consideration paid and liabilities transferred.

Effective Date and Transition

7. After adoption of this issue paper, the NAIC will release an amended Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the amended SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2010.

DISCUSSION

8. This issue paper will expand the exceptions to retroactive reinsurance to more easily allow property and casualty reinsurers to transfer existing blocks of business that the company is no longer actively writing and marketing. Although paragraph 28 of SSAP No. 62 notes that reinsurance of existing
liabilities is subject to abuse, the Statutory Accounting Principles Working Group determined that the requirements in this statement were sufficient to mitigate the concerns which would otherwise require retroactive accounting treatment.

9. It is contemplated that insurers and reinsurers would primarily use this option to exit unprofitable lines or products or as a way to cede off business the company is no longer writing. As it is possible that circumstances that might have made the product unattractive can change, this guidance is not intended to permanently prevent a company from reentering a line that was previously ceded in run-off. If questioned, the reporting entity shall be able to explain to the satisfaction of the affected states the change in circumstances regarding why a product that was previously considered a run-off product is now actively marketed.

10. Reinsurance between affiliates can result in abuse that retroactive reinsurance accounting is designed to prevent. The subparagraph 31.e. exception for property and casualty run-off agreements is not intended to be applied to agreements between affiliated reinsurers or reinsurers under common control. There is a currently existing exception to retroactive reinsurance accounting for intercompany reinsurance agreements and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction in subparagraph 31.d. This issue paper does not affect or modify that guidance.

11. Retroactive reinsurance agreements between affiliates that result in surplus gain to the ceding entity, receive an accounting penalty under SSAP No. 62, paragraph 32. This issue paper does not affect or modify that guidance.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
12. As noted above existing property and casualty reinsurance accounting guidance is in SSAP No. 62. Tracked changes to SSAP No. 62 proposed by this statement are shown in appendix A. The exceptions to retroactive reinsurance accounting are a statutory accounting concept.

RELEVANT LITERATURE

Statutory Accounting
- SSAP No. 62—Property and Casualty Reinsurance
- Issue Paper No. 75—Property and Casualty Reinsurance

Generally Accepted Accounting Principles
- FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113) with modification and FASB Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises is adopted with modification in SSAP No. 62 and discussed in Issue Paper No. 75. This issue paper does not change the previous review of GAAP statements.

State Regulations
- No additional guidance obtained from state statutes or regulations.
Initial Transaction
Paid Loss or Ceded Premium?

Illustration of the rationale for treating the initial transaction as a paid loss by the Cedent/Transferor and a negative paid loss by the Reinsurer/Transferee.

Rationale:
1. This is a transfer of an existing block of business in which typically all premiums have been earned. The cedent is essentially transferring the reserves on an existing block of runoff business for a final negotiated premium.
2. Treating the initial transaction as ceded premium would distort the income statement and standard ratios of the cedent.
3. Additionally, Schedule P for the Cedent/Transferor would be distorted since existing loss reserves would never be paid, resulting in favorable reserve development in Schedule P.
4. Treating the initial transaction as a paid loss is consistent with similar transactions like assumption reinsurance and LPTs (when there is no surplus gain) and better presents the true economics of the transaction.
5. Treating the initial transaction as a paid loss preserves the logical data flow in all of the underwriting and investment exhibits, Schedule P and Schedule F.

Illustration: Assume $110,000 of earned premiums and the transfer of a runoff block of business representing $50,000 in reserves for $50,000 cash

<table>
<thead>
<tr>
<th>Cedent I/S</th>
<th>Before Transaction</th>
<th>Recorded As Paid Loss</th>
<th>Recorded As Ceded Premium</th>
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<tbody>
<tr>
<td>Premiums Earned</td>
<td>110,000</td>
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<td>60,000</td>
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<tr>
<td>Losses Incurred</td>
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<td>85,000</td>
<td>35,000</td>
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<tr>
<td>Other U/W Expenses</td>
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<td>30,000</td>
<td>30,000</td>
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<tr>
<td>Net U/W Gain (Loss)</td>
<td>(5,000)</td>
<td>(5,000)</td>
<td>(5,000)</td>
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<td>Investment Income</td>
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<td>7,000</td>
<td>7,000</td>
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<tr>
<td>Other Income</td>
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<tr>
<td>Net income</td>
<td>3,000</td>
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<tr>
<td>Loss Ratio</td>
<td>77%</td>
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<td>58%</td>
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<tr>
<td>Expense Ratio</td>
<td>27%</td>
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<td>50%</td>
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<tr>
<td>Combined Ratio</td>
<td>104%</td>
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<td>108%</td>
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<tr>
<td>Cedent B/S</td>
<td>Before Transaction</td>
<td>Recorded As Paid Loss</td>
<td>Recorded As Ceded Premium</td>
</tr>
<tr>
<td>----------------------------------------</td>
<td>--------------------</td>
<td>-----------------------</td>
<td>---------------------------</td>
</tr>
<tr>
<td>Cash &amp; Invested Assets</td>
<td>445,000</td>
<td>395,000</td>
<td>395,000</td>
</tr>
<tr>
<td>Reinsurance Recoverable on Unpaid Losses</td>
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<td>EDP Equipment</td>
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<tr>
<td>Other Assets</td>
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<tr>
<td>Total Assets</td>
<td>500,000</td>
<td>450,000</td>
<td>450,000</td>
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<tr>
<td>Unpaid Losses and LAE</td>
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<td>Unearned Premium</td>
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<td>A/P and Accrued Expenses</td>
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<td>Other Liabilities</td>
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<tr>
<td>Total Liabilities</td>
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<tr>
<td>Common Stock</td>
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<td>90,000</td>
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<tr>
<td>Unassigned Surplus</td>
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<td>Total Capital &amp; Surplus</td>
<td>275,000</td>
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<tr>
<td>Total Liab., Capital &amp; Surplus</td>
<td>500,000</td>
<td>450,000</td>
<td>450,000</td>
</tr>
</tbody>
</table>

Conclusion:
1. If you report the consideration paid by the Cedent/Transferor as a Paid Loss, there is no net effect on the balance sheet or income statement or key underwriting ratios.
2. If you report the consideration paid by the Cedent/Transferor as a Ceded Premium, the effect on the income statement and underwriting ratios is dramatic.
3. Additionally, Schedule P for the Cedent/Transferor would be distorted since existing loss reserves would never be paid, resulting in favorable reserve development in Schedule P.
EXHIBIT A: Illustration of Marked Changes to Amended SSAP No. 62R

The following depicts the amendments from this issue paper as “marked changes” (new text underlined):

**Property and Casualty Reinsurance**

**SCOPE OF STATEMENT**

1. This statement establishes statutory accounting principles for property and casualty reinsurance. A wide range of methods for structuring reinsurance arrangements can be employed depending on the requirements of individual companies. This statement deals with the more commonly employed methods.

**SUMMARY CONCLUSION**

**General**

2. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. The transaction whereby a reinsurer cedes all or part of the reinsurance it has assumed to another reinsurer is known as a retrocession.

3. Reinsurance has many beneficial purposes. Among them are that it enables an insurance entity to (a) expand its capacity, (b) share large risks with other insurers, (c) spread the risk of potential catastrophes and stabilize its underwriting results, (d) finance expanding volume by sharing the financial burden of reserves, (e) withdraw from a line or class of business, and (f) reduce its net liability to amounts appropriate to its financial resources.

4. Reinsurance agreements are generally classified as treaty or facultative. Treaty reinsurance refers to an arrangement involving a class or type of business written, while facultative reinsurance involves individual risks offered and accepted.

5. Reinsurance coverage can be pro rata (i.e., proportional reinsurance) where the reinsurer shares a pro rata portion of the losses and premium of the ceding entity or excess of loss (i.e., non-proportional) where the reinsurer, subject to a specified limit, indemnifies the ceding entity against the amount of loss in excess of a specified retention. Most reinsurance agreements fall into one of the following categories:

   I. Treaty Reinsurance Contracts—Pro Rata:

      A. Quota Share Reinsurance—The ceding entity is indemnified against a fixed percentage of loss on each risk covered in the agreement;

      B. Surplus Share Reinsurance—The ceding entity establishes a retention or "line" on the risks to be covered and cedes a fraction or a multiple of that line on each policy subject to a specified maximum cession;

   II. Treaty Reinsurance Contracts—Excess of Loss:

      A. Excess Per Risk Reinsurance—The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each risk covered by a treaty;

      B. Aggregate Excess of Loss Reinsurance—The ceding entity is indemnified against the amount by which the ceding entity’s net retained losses incurred during a specific period exceed either a predetermined dollar amount or a percentage of the entity’s subject premiums for the specific period subject to a specified limit;
III. Treaty Reinsurance Contracts—Catastrophe: The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to an accumulation of losses resulting from a catastrophic event or series of events;

IV. Facultative Reinsurance Contracts—Pro Rata: The ceding entity is indemnified for a specified percentage of losses and loss expenses arising under a specific insurance policy in exchange for that percentage of the policy's premium;

V. Facultative Reinsurance Contracts—Excess of Loss: The ceding entity is indemnified, subject to a specified limit, for losses in excess of its retention with respect to a particular risk.

Characteristics of Reinsurance Agreements

6. Common contract provisions that may affect accounting practices include:

a. Reporting responsibility of the ceding entity—Details required and time schedules shall be established;

b. Payment terms—Time schedules, currencies intended, and the rights of the parties to withhold funds shall be established;

c. Payment of premium taxes—Customarily the responsibility of the ceding entity, a recital of nonliability of the reinsurer may be found;

d. Termination—May be on a cut-off or run-off basis. A cut-off provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A run-off provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the policies expire or are canceled; and

e. Insolvency clause—Provides for the survival of the reinsurer’s obligations in the event of insolvency of the ceding entity, without diminution because of the insolvency.

7. Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the reporting entity, nor grounds for retroactive revocation or retroactive cancellation of any contracts of the reporting entity.

Required Terms for Reinsurance Agreements

8. In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed by the ceding entity for reinsurance recoverable where the agreement was entered into after the effective date of these requirements (see paragraphs 86–90 and 8791) unless each of the following conditions is satisfied:

a. The agreement must contain an acceptable insolvency clause;

b. Recoveries due the ceding entity must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding entity;

c. The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly, from the reinsurer to the ceding entity or from the ceding entity to the reinsurer;
d. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis, unless there is no activity during the period. The report of premiums and losses shall set forth the ceding entity’s total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding entity and reinsurer will be recorded and reported on a basis consistent with this statement; and

e. With respect to retroactive reinsurance agreements, the following additional conditions apply:

i. The consideration to be paid by the ceding entity for the retroactive reinsurance must be a sum certain stated in the agreement;

ii. Direct or indirect compensation to the ceding entity or reinsurer is prohibited;

iii. Any provision for subsequent adjustment on the basis of actual experience in regard to policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a retroactive reinsurance transaction, except that provision may be made for the ceding entity’s participation in the reinsurer’s ultimate profit, if any, under the agreement;

iv. A retroactive reinsurance agreement shall not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding entity.

Reinsurance Agreements with Multiple Cedents

9. Reinsurance agreements with multiple cedents require allocation agreements. The allocation agreement can be part of the reinsurance agreement or a separate agreement. If the agreement has multiple cedents:

a. The allocation must be in writing and

b. The terms of the allocation agreement must be fair and equitable.

Reinsurance Contracts Must Include Transfer of Risk

10. The essential ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the agreement contains this essential element of risk transfer, no credit shall be recorded.

11. Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.

12. Determining whether an agreement with a reinsurer provides indemnification against loss or liability (transfer of risk) relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding entity and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of insurance risk to which the reinsurer is subject (e.g., experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance
contract) or (b) delay the timely reimbursement of claims by the reinsurer (e.g., payment schedules or accumulating retentions from multiple years).

13. Indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance requires both of the following:
   
a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and
b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

14. A reinsurer shall not have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Implicit in this condition is the requirement that both the amount and timing of the reinsurer’s payments depend on and directly vary with the amount and timing of claims settled by the ceding entity. Contractual provisions that delay timely reimbursement to the ceding entity prevent this condition from being met.

15. The ceding entity’s evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate.

16. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 15, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance agreements has been assumed by the reinsurer. In this narrow circumstance, the reinsurer’s economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding entity on the retained portions of the underlying insurance contracts, so that the reinsurer’s exposure to loss is essentially the same as the reporting entity’s.

17. Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer’s payment to the ceding entity depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurer’s reimbursement to the ceding entity shall be closely scrutinized.

Accounting for Reinsurance

18. Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Certain assets and liabilities are created by entities when they engage in reinsurance contracts. Reinsurance assets meet the definition of assets as defined by SSAP No. 4—Assets and Nonadmitted Assets and are admitted to the extent they conform to the requirements of this statement.
19. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which issued the underlying policy. Specific accounting rules for underwriting pools and associations are addressed in SSAP No. 63—Underwriting Pools and Associations Including Intercompany Pools.

20. Reinsurance recoverable on loss payments is an admitted asset. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64), reinsurance recoverables on paid losses shall be reported as an asset without any available offset. Unauthorized reinsurance is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue authorized reinsurance shall be reflected as a liability.

21. Funds held or deposited with reinsured companies, whether premiums withheld as security for unearned premium and outstanding loss reserves or advances for loss payments, are admitted assets provided they do not exceed the liabilities they secure and provided the reinsured is solvent. Those funds which are in excess of the liabilities, and any funds held by an insolvent reinsured shall be nonadmitted.

22. Prospective reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance agreement may include both prospective and retroactive reinsurance provisions.

23. The distinction between prospective and retroactive reinsurance agreements is based on whether the agreement reinsures future or past insured events covered by the underlying insurance policies. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance agreement. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance agreement is a retroactive agreement. (However, a reinsurance agreement that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance agreement.)

24. It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the agreement is substantively prospective shall be determined based on the facts and circumstances. However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the agreement is domiciled outside the U.S. and is not affiliated with such reinsurer, if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement. This presumption shall not apply to: (a) facultative reinsurance contracts, nor to (b) reinsurance agreements with more than one reinsurer which are signed by the lead reinsurer (i.e., the reinsurer setting the terms of the agreement for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance agreement, nor to (c) reinsurance agreements with more than one reinsurer (whether signed by the lead reinsurer or not) which were entered into, renewed or amended on or before December 31, 1996, (and which were not renewed or amended after that date) if reinsurers representing more than 50% of the capacity on the agreement have signed cover notes, placement slips or similar documents describing the essential terms of coverage and exclusions within nine months after the commencement of the policy period covered by the reinsurance arrangement. Also exempt from this presumption are reinsurance agreements where one of the parties is in conservation, rehabilitation, receivership or liquidation proceedings.
25. Prospective and retroactive provisions included within a single agreement shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single agreement is impracticable, the agreement shall be accounted for as a retroactive agreement provided the conditions for reinsurance accounting are met.

Accounting for Prospective Reinsurance Agreements

26. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding entity and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided or, if applicable, until the reinsurer’s maximum liability under the agreement has been exhausted. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid. Reinstatement premium, if any, shall be earned over the period from the reinstatement of the limit to the expiration of the agreement.

27. Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current period statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, reinsurance recoverables on loss and loss adjustment expense payments, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

Accounting for Retroactive Reinsurance Agreements

28. Certain reinsurance agreements which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the agreement. Due to potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results, special accounting treatment for these agreements is warranted.

29. All retroactive reinsurance agreements entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) shall be accounted for and reported in the following manner:

a. The ceding entity shall record, without recognition of the retroactive reinsurance, loss and loss expense reserves on a gross basis on the balance sheet and in all schedules and exhibits;

b. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;

c. The ceding entity and the assuming entity shall report by write-in item on the balance sheet, the total amount of all retroactive reinsurance, identified as retroactive reinsurance reserve ceded or assumed, recorded as a contra-liability by the ceding entity and as a liability by the assuming entity;

d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;

e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;

f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in subparagraph 29.j.;
g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;

h. The ceding entity shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;

i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding subparagraph 29.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;

j. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding subparagraphs 29.h. and 29.i., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry on the balance sheet shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry shall be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to unassigned funds (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and

k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

(For an illustration of ceding entity accounting entries see Question 33 in Exhibit A.)

30. Portfolio reinsurance is the transfer of an insurer’s entire liability for in force policies or outstanding losses, or both, of a segment of the insurer’s business. Loss portfolio transactions are to be accounted for as retroactive reinsurance.

31. The accounting principles for retroactive reinsurance agreements in paragraph 29 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):

a. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

b. Novations, (i.e., (i) transactions in which the original direct insurer’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (ii) transactions in which the original assuming entity’s obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;
c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business; or

d. Intercompany reinsurance agreements, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction; or

e. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs 68-71.

32. Retroactive reinsurance agreements resulting in surplus gain to the ceding entity (with or without risk transfer) entered into between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) shall be reported as follows:

a. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and

b. No deduction shall be made from loss and loss adjustment expense reserves on the ceding entity’s balance sheet, schedules, and exhibits.

33. The accounting and reporting provisions applicable to retroactive reinsurance apply to all transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation, or receivership. The requirement to include stipulated contract provisions in the reinsurance agreements shall not apply to these transactions, with written approval of the ceding entity’s domiciliary commissioner.

34. Novations meeting the requirements of subparagraph 31.b. shall be accounted for as prospective reinsurance agreements. The original direct insurer, or the original assuming insurer, shall report amounts paid as a reduction of written and earned premiums, and unearned premiums to the extent that premiums have not been earned. Novated balances (e.g., loss and loss adjustment expense reserves) shall be written off through the accounts, exhibits, and schedules in which they were originally recorded. The assuming insurer shall report amounts received as written and earned premiums, and obligations assumed as incurred losses in the statement of income.

**Deposit Accounting**

35. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding entity and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding entity if (i) the assuming entity is licensed, accredited or otherwise qualified in the ceding entity’s state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding entity as described in Appendix A-785;

b. Throughout the life of the agreement, receipts and disbursements shall be recorded through the deposit/liability accounts;

c. When individual case reserves are the basis for the deposit and the assuming entity pays in excess of the amount transferred by the ceding entity, the amount paid in excess of the deposit received shall be recognized as a loss by the assuming entity and as a gain by the ceding entity as Other Income in the statement of income;
When the agreement is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded in the Other Income or Loss account as a loss to the reinsurer and as a gain in the Other Income or Loss account by the reinsured;

With regard to bulk reserves, (i.e., IBNR) it shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the liability shall be recorded as a loss recognized by the assuming entity. Conversely, the ceding entity shall increase its deposit (asset) and outstanding loss liability;

No deduction shall be made from the loss and loss adjustment expense reserves on the ceding entity’s balance sheet, schedules, and exhibits; and

The assuming entity shall record net consideration to be returned to the ceding entity as liabilities.

Assumed Reinsurance

36. Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as agents’ balances or uncollected premiums. Where the ceding entity withholds premium funds pursuant to the terms of the reinsurance agreement, such assets shall be shown by the assuming entity as funds held by or deposited with reinsured companies. Reporting entities shall record any interest earned or receivable on the funds withheld as a component of aggregate write-ins for miscellaneous income.

37. If the assuming entity receives reinsurance premium prior to the effective date of the reinsurance contract, consistent with SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 14, advance premiums shall be reported as a liability in the statutory financial statement and not considered income until the effective date of the coverage. Such amounts are not included in written premium or the unearned premium reserve. If the assuming entity receives reinsurance premium after the effective date of the reinsurance contract but prior to the due date, the amount received shall be reported as a reduction of the asset for deferred but not yet due (earned but unbilled premiums).

38. Reinsurance premiums more than 90 days overdue shall be nonadmitted except (a) to the extent the assuming entity maintains unearned premium and loss reserves as to the ceding entity, under principles of offset accounting as discussed in SSAP No. 64, or (b) where the ceding entity is licensed and in good standing in assuming entity’s state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the agreement stood on the date of execution). In the absence of a specific contract date, reinsurance premiums will be deemed due thirty (30) days after the date on which (i) notice or demand of premium due is provided to the ceding entity or (ii) the assuming entity books the premium (see SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers).

39. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding entity and the transmittal of information and entry on the books of the assuming entity. Assuming companies shall estimate unreported premiums and related costs to the extent necessary to prevent material distortions in the loss development contained in the assuming entity’s annual statement schedules where calendar year premiums are compared to accident year losses.

40. Proportional reinsurance (i.e., first dollar pro rata reinsurance) premiums shall be allocated to the appropriate annual statement lines of business in the Underwriting and Investment exhibits. Non-proportional assumed reinsurance premiums shall be classified as reinsurance under the appropriate subcategories.
41. Assumed retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in subparagraph 29.k.

42. Amounts payable by reinsurers on losses shall be classified as unpaid losses. Assumed reinsurance payable on paid losses shall be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business shall be netted with ceded losses on the balance sheet and listed separately by annual statement line of business in the Underwriting and Investment exhibits.

**Ceded Reinsurance**

43. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with SSAP No. 64, ceded reinsurance premiums payable may be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right of offset exists.

44. With regard to reinsurance premium paid prior to the effective date of the contract, the ceding entity shall reflect the prepaid item as a write-in admitted asset and it should not be recognized in the income statement until the effective date of the coverage. Such amounts are not included in ceded written premiums or ceded unearned premium but should be subject to impairment analysis. With regard to reinsurance premium paid by ceding entity after the reinsurance contract is in effect but prior to the due date, the ceding entity shall treat this item as a reduction to the liability for ceded reinsurance premiums payable. That liability reflects not only premiums unpaid but also amounts booked but deferred and not yet due.

45. Amounts withheld by the ceding entity that would otherwise be payable under the reinsurance agreement shall be reported as funds held by entity under reinsurance treaties. Reporting entities shall record any interest due or payable on the amounts withheld as a component of aggregate write-ins for miscellaneous income.

46. Ceded reinsurance transactions shall be classified in the annual statement line of business which relates to the direct or assumed transactions creating the cession or retrocession.

47. Ceded retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in subparagraph 29.k.

**Adjustable Features/Retrospective Rating**

48. Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. The accounting for common examples is outlined in the following paragraphs:

**Commission Adjustments**

49. An accrual shall be maintained for the following adjustable features based upon the experience recorded for the accounting period:

   a. Contingent or Straight Profit—The reinsurer returns to the ceding entity a stipulated percentage of the profit produced by the business assumed from the ceding entity. Profit may be calculated for any specified period of time, but the calculation is often based on an average over a period of years; and

   b. Sliding Scale—A provisional rate of commission is paid over the course of the agreement, with a final adjustment based on the experience of the business ceded under the agreement.
Premium Adjustments

50. If the reinsurance agreement incorporates an obligation on the part of the ceding entity to pay additional premium to the assuming entity based upon loss experience under the agreement, a liability in the amount of such additional premium shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to pay such additional premium occur(s). The assuming entity shall recognize an asset in a consistent manner. If the reinsurance agreement incorporates an obligation on the part of the assuming entity to refund to the ceding entity any portion of the consideration received by the assuming entity based upon loss experience under the agreement, an asset in the amount of any such refund shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The initial provisional or deposit premium is recalculated retrospectively, based on loss experience under the agreement during a specified period of time; the calculation is often based on an average over a period of years. The assuming entity shall recognize a liability in a consistent manner.

Adjustments in the Amount of Coverage

51. The amount of coverage available for future periods is adjusted, upward or downward, based on loss experience under the agreement during a specified period of time. If the reinsurance agreement incorporates a provision under which the reinsurance coverage afforded to the ceding entity may be increased or reduced based upon loss experience under the agreement, an asset or a liability shall be recognized by the ceding entity in an amount equal to that percentage of the consideration received by the assuming entity which the increase or reduction in coverage represents of the amount of coverage originally afforded. The asset or liability shall be recognized during the accounting period in which the loss event(s) (or absence thereof) giving rise to the increase or decrease in reinsurance coverage occur(s), and shall be amortized over all accounting periods for which the increased or reduced coverage is applicable. The term “consideration” shall mean, for this purpose, the annualized deposit premium for the period used as the basis for calculating the adjustment in the amount of coverage to be afforded thereafter under the agreement.

Impairment

52. Include as a nonadmitted asset, amounts accrued for premium adjustments on retrospectively rated reinsurance agreements with respect to which all uncollected balances due from the ceding company have been classified as nonadmitted.

Commissions

53. Commissions payable on reinsurance assumed business shall be included as an offset to Agents’ Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business shall be included as an offset to Ceded Reinsurance Balances Payable.

54. If the ceding commission paid under a reinsurance agreement exceeds the anticipated acquisition cost of the business ceded, the ceding entity shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized pro rata over the effective period of the reinsurance agreement in proportion to the amount of coverage provided under the reinsurance contract.

Provision for Reinsurance

55. The NAIC Annual Statement Instructions for Property and Casualty Companies for Schedule F—Provision for Overdue Reinsurance, provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if an entity’s experience indicates that a higher amount should be provided. The minimum reserve Provision for Reinsurance is recorded as a liability and the change between years is recorded as a gain or loss directly to unassigned funds (surplus). Any reserve over the minimum amount shall be recorded on the statement of income by reversing the accounts previously utilized to establish the reinsurance recoverable.
56. The provision for reinsurance is calculated separately for unauthorized and authorized companies. An authorized reinsurer is licensed, accredited or approved by the ceding entity’s state of domicile; an unauthorized reinsurer is not so licensed, accredited or approved.

Disputed Items

57. Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance agreement or may even attempt to nullify an entire agreement. A ceding entity, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. A ceding entity shall take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

58. Items in dispute are those claims with respect to which the ceding entity has received formal written communication from the reinsurer denying the validity of coverage.

Uncollectible Reinsurance

59. Uncollectible reinsurance balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

Commutations

60. A commutation of a reinsurance agreement, or any portion thereof, is a transaction which results in the complete and final settlement and discharge of all, or the commuted portion thereof, present and future obligations between the parties arising out of the reinsurance agreement.

61. In commutation agreements, an agreed upon amount determined by the parties is paid by the reinsurer to the ceding entity. The ceding entity immediately eliminates the reinsurance recoverable recorded against the ultimate loss reserve and records the cash received as a negative paid loss. Any net gain or loss shall be reported in underwriting income in the statement of income.

62. The reinsurer eliminates a loss reserve carried at ultimate cost for a cash payout calculated at present value. Any net gain or loss shall be reported in underwriting income in the statement of income.

63. Commuted balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

National Flood Insurance Program

64. The National Flood Insurance Program was created by the Federal Emergency Management Agency (FEMA) and is designed to involve private insurers in a write-your-own (WYO) flood insurance program financially backed by FEMA at no risk to the insurer. To become a participating WYO entity, the entity signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

65. Premium rates are set by FEMA. The WYO participating companies write the flood insurance coverage qualifying for the program on their own policies, perform their own underwriting, premium collections, claim payments, administration, and premium tax payments for policies written under the program.

66. Monthly accountings are made to FIA and participants draw upon FEMA letters of credit for deficiencies of losses, loss expenses, and administrative expenses in excess of premiums, subject to certain percentage limitations on expenses.

67. Balances due from or to FEMA shall be reported as ceded reinsurance balances receivable or payable.
Accounting for the Transfer of Property and Casualty Run-off Agreements

68. Property and casualty run-off agreements are reinsurance or retrocession agreements that are intended to transfer essentially all of the risks and benefits of a specific line of business or market segment that is no longer actively marketed by the transferring insurer or reinsurer. A property and casualty run-off agreement is not a novation as the transferring insurer or reinsurer remains primarily liable to the policyholder or ceding entity under the original contracts of insurance or reinsurance. Reinsurance agreements between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) are not eligible for the exception for property and casualty run-off agreements in subparagraph 31.e. of SSAP No. 62R.

Criteria

69. The accounting treatment for property and casualty run-off agreements must be approved by the domiciliary regulators of the transferring entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement) and the assuming entity. If the transferring entity and assuming entity are domiciled in the same state, then the regulator of the state where the majority of the transferred liabilities is located shall be asked to approve the accounting treatment. In determining whether to approve an agreement for this accounting treatment, the regulators shall require the following:

a. Assuming Entity Properly Licensed – The entity assuming the run-off agreement must have the appropriate authority or license to write the business being assumed.

b. Limits and Coverages – The reinsurance or retrocession agreement shall provide the same limits and coverages that were afforded in the original insurance or reinsurance agreement.

c. Non-recourse – The reinsurance or retrocession agreement shall not contain any adjustable features or profit share or retrospective rating, and there shall be no recourse (other than normal representations and warranties that would be associated with a purchase and sale agreement) directly or indirectly against the transferring entity.

d. Risk Transfer – The reinsurance or retrocession agreement must meet the requirements of risk transfer as described in this statement.

e. Financial Strength of Reinsurer – The assuming reinsurer shall have a financial strength rating from at least two independent rating agencies (from NAIC acceptable rating agencies) which is equal to or greater than the current ratings of the transferring entity. The lowest financial strength rating received from an NAIC acceptable rating organization rating agency will be used to compare the financial strength ratings of the transferring and assuming entities.

f. Assessments – The assuming reinsurer or retrocessionaire (if required in the original reinsurance contract) shall be financially responsible for any and all assessments, including guaranty fund assessments, that are assessed against the transferring entity related to the insurance business being assumed.

g. Applicable Only to “Run-off” Business – The reinsurance or retrocession agreement shall only cover liabilities relating to a line(s) of business or specific market segments no longer actively marketed by the transferring entity.

h. Non-cancelable Reinsurance – The reinsurance or retrocessional coverage provided by the proposed agreement cannot be cancelable by either party for any reason. (However, this provision will not override standard contracts law and principles...
and will not prevent any remedies, including rescission or termination that might be available for breach, misrepresentation, etc.)

Statutory Schedules and Exhibits

70. At the inception of the transaction, the transferring entity shall record the consideration paid to the assuming entity as a paid loss. If the consideration paid by the transferring entity is less than the loss reserves transferred, the difference shall be recorded by the ceding entity as a decrease in losses incurred. The assuming entity shall record the consideration received as a negative paid loss. In addition, the transferring entity shall record an increase to ceded reinsurance recoverable for the amount of the transferred reserve. Journal entries illustrating these transactions, including situations in which the transaction includes an unearned premium reserve, are included in Exhibit B of this Statement.

71. The assuming entity will report the business in the same line of business as reported by the original insurer or reinsurer. The assuming entity will report the business at the same level of detail using the appropriate statutory schedules and exhibits.

Disclosures

68-72. Unsecured Reinsurance Recoverables:

a. If the entity has with any individual reinsurers, authorized or unauthorized, an unsecured aggregate recoverable for losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium, that exceeds 3% of the entity’s policyholder surplus, list each individual reinsurer and the unsecured aggregate recoverable pertaining to that reinsurer; and

b. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting entity, and the total unsecured aggregate recoverables for the entire group.

69-73. Reinsurance Recoverables in Dispute—Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified if the amounts in dispute from any entity (and/or affiliate) exceed 5% of the ceding entity’s policyholders surplus or if the aggregate of all disputed items exceeds 10% of the ceding entity’s policyholders surplus. Notification means a formal written communication from a reinsurer denying the validity of coverage.

70-74. Uncollectible Reinsurance—Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

a. Losses incurred;

b. Loss adjustment expenses incurred;

c. Premiums earned; and

d. Other.

74-75. Commutation of Ceded Reinsurance—Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):
Transfer of Property and Casualty Reinsurance Agreements in Run-Off

72-76. **Retroactive Reinsurance**—The table illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under Retroactive Reinsurance in the Notes to Financial Statements section shall be completed for all retroactive reinsurance agreements that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance agreement and shall utilize this number for as long as the agreement exists. Transactions utilizing deposit accounting shall not be reported in this note.

73-77. **Reinsurance Assumed and Ceded**—The tables illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under “Reinsurance Assumed and Ceded in the Notes to Financial Statements” section shall be completed as follows:

a. The financial statements shall disclose the maximum amount of return commission which would have been due reinsurers if all reinsurance were canceled with the return of the unearned premium reserve; and

b. The financial statements shall disclose the accrual of additional or return commission, predicated on loss experience or on any other form of profit sharing arrangements as a result of existing contractual arrangements.

74-78. A specific interrogatory requires information on reinsurance of risk accompanied by an agreement to release the reinsurer from liability, in whole or in part, from any loss that may occur on the risk or portion thereof.

75-79. Disclosures for paragraphs 76-81-80-85 represent annual statement interrogatories, which are required to be included with the annual audit report beginning with audit reports on financial statements as of and for the period ended December 31, 2006. The disclosures required within paragraphs 76-81-80-85 shall be included in accompanying supplemental schedules of the annual audit report beginning in year-end 2006. These disclosures shall be limited to reinsurance contracts entered into, renewed or amended on or after January 1, 1994. This limitation applies to the annual audit report only and does not apply to the statutory annual statement interrogatories and the reinsurance summary supplemental filing.

76-80. Disclose if any risks are reinsured under a quota share reinsurance contract with any other entity that includes a provision that would limit the reinsurer’s losses below the stated quota share percentage (e.g. a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)? If yes, indicate the number of reinsurance contracts containing such provisions and if the amount of reinsurance credit taken reflects the reduction in quota share coverage caused by any applicable limiting provision(s).

77-81. Disclose if the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

a. A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;
b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

c. Aggregate stop loss reinsurance coverage;

d. A unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions which are only triggered by a decline in the credit status of the other party;

e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

f. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

78.82. Disclose if the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:

a. The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

b. Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates in separate reinsurance contract.

79.83. If affirmative disclosure is required for paragraph 77 or 78, provide the following information:

a. A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting paragraph 77 or 78;

b. A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved; and

c. The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

80.84. Except for transactions meeting the requirements of paragraph 31 of SSAP No. 62R—Property and Casualty Reinsurance, disclose if the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

a. Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or

b. Accounted for that contract as reinsurance under GAAP and as a deposit under SAP?
84. If affirmative disclosure is required for paragraph 80, explain in a supplemental filing why the contract(s) is treated differently for GAAP and SAP.

86. Disclosures for the Transfer of Property and Casualty Run-off Agreements
   a. Disclose if the reporting entity has entered into any agreements which have been approved by their domiciliary regulator and have qualified pursuant to SSAP No. 62R, subparagraph 31.e., Accounting for the Transfer of Property and Casualty Run-off Agreements.
   b. If affirmative, provide a description of the agreement and the amount of consideration paid and liabilities transferred.

82. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature
83. This statement adopts FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113) with modification and FASB Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises with modification for the following:
   a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be reported as a contra-liability netted against the liability for gross losses and loss adjustment expenses;
   b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums;
   c. The gain created by a retroactive reinsurance agreement because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the statement of income as a write-in gain in other income by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance agreement is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid;
   d. This statement requires that a liability be established through a provision reducing unassigned funds (surplus) for unsecured reinsurance recoverables from unauthorized reinsurers and for certain overdue balances due from authorized reinsurers;
   e. Some reinsurance agreements contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. This statement requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the agreement, and the impact of early termination may only be considered at the time the agreement has actually been terminated;
   f. Structured settlements are addressed in SSAP No. 65—Property and Casualty Contracts. Statutory accounting and FAS 113 are consistent in accounting for structured settlement annuities where the reporting entity is the owner and payee and where the claimant is the payee and the reporting entity has been released from its obligation. FAS 113 distinguishes structured settlement annuities where the claimant is the payee and a legally enforceable release from the reporting entity’s liability is obtained from those where the claimant is the payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the reporting entity has not been released from its obligation; and
This statement requires that reinsurance recoverables on unpaid losses and loss adjustment expenses be presented as a contra-liability. Requirements for offsetting and netting are addressed in SSAP No. 64.

84. This statement rejects AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance. This statement incorporates Appendix A-785 as applicable.

Effective Date and Transition

85. This statement shall apply to:

a. Reinsurance agreements entered into, renewed, or amended on or after January 1, 1994. An amendment is any revision or adjustment of contractual terms. The payment of premiums or reimbursement of losses recoverable under the agreement shall not constitute an amendment; and

b. Reinsurance agreements in force on January 1, 1995, which cover losses occurring or claims made on or after that date on policies reinsured under such agreements.

86. The guidance shall not apply to:

a. Reinsurance agreements which cover only losses occurring or claims made before January 1, 1994, and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and

b. Reinsurance agreements that expired before and were not renewed or amended after January 1, 1995.

87. The guidance in paragraphs 48 through 52 shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into, renewed or amended on or after January 1, 1994.

93. This statement is effective for years beginning January 1, 2001. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. Revisions to subparagraph 31.e., related paragraphs 68-71, and new disclosures in paragraph 86 documented in Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements are effective for contracts entered on or after January 1, 2010.

AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

- FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

- FASB Emerging Issues Task Force Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises

RELEVANT ISSUE PAPERS

- Issue Paper No. 75—Property and Casualty Reinsurance

- Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements
CLASSIFYING REINSURANCE CONTRACTS

Was the contract entered into, renewed, amended, or does the contract have an anniversary date (i.e., multi-year contract) during or after 1994?

Yes → Has the reinsurer assumed significant insurance risk, both as to timing of risk (including timely reimbursement) and amount of insurance loss under the reinsured portions of the underlying contracts?

No → The contract would be “grandfathered” and accounted for in accordance with Chapter 22 of the NAIC Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies dated January 1992.

Yes → Has the reinsurer assumed substantially all of the risk relating to the reinsured portion of the underlying contract (i.e., the reinsurer is in the same economic position as the reinsured)?

No → The contract has not transferred risk and should be accounted for as a deposit. Any previously recognized gains and losses should not be restated, and existing balances should be reclassified as deposits.

Yes → The contract has transferred risk and should be accounted for as reinsurance in accordance with SSAP No. 62R.

Does the contract only reinsure losses from insured events that may occur after the date the contract is entered into?

Yes → Account for the contract as a prospective reinsurance.

No → Does the contract only reinsure losses from insured events that occurred prior to the date the contract is entered into?

Yes → Account for the contract as a retroactive unless one of the paragraph 31 exceptions are met, then account for either prospective reinsurance or as indicated.

No → Is it practicable to identify and account separately for the prospective and retroactive portions of a blended contract?

Yes → Account for the prospective and retroactive components separately.

No → No

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SSAP NO. 62R—EXHIBIT A

Implementation Questions and Answers

Applicability

1. Q: The accounting practices in SSAP No. 62R specify the accounting and reporting for reinsurance contracts. What contracts are considered reinsurance contracts for purposes of applying these accounting practices?

A: Any transaction that indemnifies an insurer against loss or liability relating to insurance risk shall be accounted for in accordance with the accounting practices included in SSAP No. 62R. Therefore, all contracts, including contracts that may not be structured or described as reinsurance, shall be accounted for as reinsurance when those conditions are met.

2. Q: The provisions of this statement will apply to (a) reinsurance contracts entered into, renewed or amended on or after January 1, 1994, and (b) any other reinsurance contracts that are in force on January 1, 1995 and cover insurable events on the underlying insurance policies that occur on or after that date. What contracts would be exempt from the new accounting rules included in SSAP No. 62R?

A: The only exempt contracts are:

1) Purely retroactive reinsurance contracts that cover only insured events occurring before January 1, 1994, provided those contracts were entered into before that date and are not subsequently amended and

2) Contracts that expired before January 1, 1995 and are not amended after that date.

3. Q: This statement is to be applied to contracts which are amended on or after January 1, 1994. What if the change in terms is not significant, or the terms changed have no financial effect on the contract?

A: In general, the term amendment should be viewed broadly to include all but the most trivial changes. Examples of amendments include, but are not limited to, replacing one assuming entity with another (including an affiliated entity), or modifying the contract's limit, coverage, premiums, commissions, or experience-related adjustable features. No distinction is made between financial and non-financial terms.

4. Q: Must the accounting provisions of SSAP No. 62R be applied to an otherwise exempt contract if the ceding entity pays additional premiums under the contract on or after January 1, 1994?

A: The answer depends on why the additional premiums are paid. If the additional premiums are the result of a renegotiation, adjustment, or extension of terms, the contract is subject to the accounting provisions of SSAP No. 62R. However, additional premiums paid without renegotiation, adjustment, or extension of terms would not make an otherwise exempt contract subject to those provisions.

5. Q: Prospective and retroactive portions of a reinsurance contract are allowed to be accounted for separately, if practicable. Can the retroactive portion of an existing contract be segregated and, therefore, exempted with other retroactive contracts covering insured events occurring prior to January 1, 1994?

A: No. The transition provisions apply to an entire contract, which is either subject to or exempt from the revised provisions of SSAP No. 62R. A ceding entity may bifurcate a contract already subject to the new accounting rules in SSAP No. 62R and then account for both the prospective and retroactive portions in accordance with the new accounting standard.
Risk Transfer

6. Q: Do the new risk transfer provisions apply to existing contracts?

A: Yes, the new risk transfer provisions apply to some existing contracts. SSAP No. 62R applies in its entirety only to existing contracts which were renewed or amended on or after January 1, 1994, or which cover losses occurring or claims made after that date. Therefore, those contracts must be evaluated to determine whether they transfer risk and qualify for reinsurance accounting. For accounting periods commencing on or after January 1, 1995, balances relating to such contracts which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption Reinsurance Contracts Must Include Transfer of Risk.

SSAP No. 62R does not apply to existing contracts which were entered into before, and were not renewed or amended on or after, January 1, 1994, and which cover only losses occurring or claims made before that date, nor to contracts which expired before, and were not renewed or amended on or after, January 1, 1995. Those contracts will continue to be accounted for in the manner provided by SSAP No. 62R before these revisions.

7. Q: How does the effective date affect the assessment of whether a significant loss to the reinsurer was reasonably possible?

A: The risk transfer assessment is made at contract inception, based on facts and circumstances known at the time. Because that point in time has passed for existing contracts, some have suggested that the risk transfer provisions be applied as of the effective date. However, that approach to the risk transfer assessment would violate the requirement to consider all cash flows from the contract. Therefore, the test must be applied from contract inception, considering the effect of any subsequent contract amendments. Careful evaluation and considered judgment will be required to determine whether a significant loss to the reinsurer was reasonably possible at inception.

8. Q: Should risk transfer be reassessed if contractual terms are subsequently amended?

A: Yes. When contractual terms are amended, risk transfer should be reassessed. For example, a contract that upon inception met the conditions for reinsurance accounting could later be amended so that it no longer meets those conditions. The contract should then be reclassified and accounted for as a deposit.

9. Q: How should the risk transfer assessment be made when a contract has been amended?

A: No particular method is prescribed for assessing risk transfer in light of a contract amendment. Whether an amended contract in substance transfers risk must be determined considering all of the facts and circumstances in light of the risk transfer requirements. Judgment also will be required to determine whether an amendment in effect creates a new contract.

10. Q: For purposes of evaluating whether a contract with a reinsurer transfers risk, what constitutes a contract?

A: A contract is not defined, but is essentially a question of substance. It may be difficult in some circumstances to determine the boundaries of a contract. For example, the profit-sharing provisions of one contract may refer to experience on other contracts and, therefore, raise the question of whether, in substance, one contract rather than several contracts exist.

The inconsistency that could result from varying interpretations of the term contract is limited by requiring that features of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers, in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured.
11. Q: If the assessment of risk transfer changes after the initial assessment at contract inception, how should the ceding entity account for the change?

   A: The status of a contract should be determinable at inception and, absent amendment, subsequent changes should be very rare. If the risk of significant loss was not deemed reasonably possible at inception, and a significant loss subsequently occurred, the initial assessment was not necessarily wrong, because remote events do occur. Likewise, once a reasonable possibility of significant loss has been established, such loss need not occur in order to maintain the contract’s status as reinsurance.

12. Q: SSAP No. 62R requires that reasonably possible outcomes be evaluated to determine the reinsurer’s exposure to significant loss. What factors should be considered in determining whether a scenario being evaluated is reasonably possible?

   A: The term reasonably possible means that the probability is more than remote. The test is applied to a particular scenario, not to the individual assumptions used in the scenario. Therefore, a scenario is not reasonably possible unless the likelihood of the entire set of assumptions used in the scenario occurring together is reasonably possible.

13. Q: In determining the amount of the reinsurer’s loss under reasonably possible outcomes, may cash flows directly related to the contract other than those between the ceding and assuming companies, such as taxes and operating expenses of the reinsurer, be considered in the calculation?

   A: No. The evaluation is based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes and, therefore, precludes considering other expenses of the reinsurer in the calculation.

14. Q: In evaluating the significance of a reasonably possible loss, should the reasonably possible loss be compared to gross or net premiums?

   A: Gross premiums should be used.

15. Q: How does a commutation clause affect the period of time over which cash flows are evaluated for reasonable possibility of significant loss to the reinsurer?

   A: All cash flows are to be assessed under reasonably possible outcomes. Therefore, unless commutation is expected in the scenario being evaluated, it should not be assumed in the calculation. Further, the assumptions used in a scenario must be internally consistent and economically rational in order for that scenario’s outcome to be considered reasonably possible.

16. Q: What interest rate should be used in each evaluated scenario to make the present value calculation?

   A: A reasonable and appropriate rate is required, which generally would reflect the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer.

17. Q: SSAP No. 62R refers to payment schedules and accumulating retentions from multiple years as features that delay timely reimbursement of claims. Does the presence of those features generally prevent a contract from meeting the conditions for reinsurance accounting?

   A: Yes. Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer’s payments to the ceding entity depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that
may affect the timing of the reinsurer's reimbursement to the ceding entity should be closely scrutinized.

18. Q: What if a contract contains a feature such as a payment schedule or accumulating retention but could still result in the reasonable possibility of significant loss to the reinsurer?

A: Both of the following conditions are required for reinsurance accounting:

a. Transfer of significant risk arising from uncertainties about both (i) the ultimate amount of net cash flows from premiums, commission, claims, and claim settlement expenses paid under a contract (underwriting risk) and (ii) the timing of the receipt and payment of those cash flows (timing risk); and

b. Reasonable possibility of significant loss to the reinsurer.

Because both condition (a) and condition (b) must be met, failure to transfer significant timing and underwriting risk is not overcome by the possibility of significant loss to the reinsurer.

19. Q: Is it permissible to evaluate timely reimbursement on a present value basis?

A: No. The word timely is used in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

While the test for reasonable possibility of significant loss to the reinsurer provides for a present value-based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (condition a above), not the reasonable possibility of significant loss (condition b above). Accordingly, timely reimbursement should be evaluated based solely on the length of time between payment of the underlying reinsured losses and reimbursement by the reinsurer.

20. Q: Are there any circumstances under which the conditions for risk transfer need not be met?

A: Yes. An extremely narrow and limited exemption is provided for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. When substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. To qualify under this exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. The reinsurer's economic position must be virtually equivalent to having written the relevant portions of the reinsured contracts directly.

21. Q: In determining whether a reinsurance contract qualifies under the exception referred to in the preceding question, how should the economic position of the reinsurer be assessed in relation to that of the ceding entity?

A: The assessment should be made by comparing the net cash flows of the reinsurer under the reinsurance contract with the net cash flows of ceding entity on the reinsured portions of the underlying insurance contracts. This may be relatively easy for reinsurance of individual risks or for unlimited-risk quota-share reinsurance, because the premiums and losses on these types of reinsurance generally are the same as the premiums and losses on the reinsured portions of the underlying insurance policies.

In other types of reinsurance, determining the reinsurer’s net cash flows relative to the insurer is likely to be substantially more difficult. For example, it generally would be difficult to demonstrate that the ceding entity’s premiums and losses for a particular layer of insurance are the same as the reinsurer’s premiums and losses related to that layer. If the economic position of the reinsurer relative to the insurer cannot be determined, the contract would not qualify under the exception.
Accounting Provisions

22. Q: An existing contract that was accounted for as reinsurance no longer qualifies for reinsurance accounting under the new accounting rules included in SSAP No. 62R. How should the ceding and assuming companies account for the contract in future periods?

A: Because the statement of income cannot be restated, previously recognized gains and losses are not revised. If the contract was entered into before, and not renewed or amended on or after, January 1, 1994 and covers only losses occurring or claims made before that date, or the contract expired before January 1, 1995 and was not renewed or amended on or after that date, it would continue to be accounted for in the manner provided before these revisions.

For accounting periods commencing on or after January 1, 1995, existing balances relating to contracts which do not transfer insurance risk and which were entered into on or after January 1, 1994 (covering losses occurring or claims made after that date) would be reclassified as deposits.

Premium payments to a reinsurer would be recorded as deposits. Likewise, losses recoverable from a reinsurer would not be recognized as receivables. Rather, any reimbursement for losses would be accounted for upon receipt as a refund of a deposit.

23. Q: What is the definition of past insurable events that governs whether reinsurance coverage is prospective or retroactive? For example, could a reinsurance contract that covers losses from asbestos and pollution claims on occurrence-based insurance policies effective during previous periods be considered prospective if the reinsurance coverage is triggered by a court interpretation that a loss is covered within the terms of the underlying insurance policies?

A: The distinction between prospective and retroactive reinsurance is based on whether a contract reinsures future or past insured events covered by the underlying reinsurance contracts. In the example above, the insured event is the occurrence of loss within the coverage of the underlying insurance contracts, not the finding of a court. Therefore, the fact that the asbestos exposure or pollution is covered under insurance policies effective during prior periods makes the reinsurance coverage in this example retroactive.

24. Q: Would the answer to the above question change if the reinsurance were written on a claims-made basis?

A: No. The form of the reinsurance—whether claims-made or occurrence-based—does not determine whether the reinsurance is prospective or retroactive. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract.

25. Q: What is the effect of adjustments to future premiums or coverage in determining whether reinsurance is prospective or retroactive?

A: Adjustments to future premiums or coverage may affect the accounting for a reinsurance contract. Whenever an adjustment results in a reinsurer providing new or additional coverage for past insurable events, that coverage is retroactive. For example, if subsequent years’ premiums under a multiple accident year contract create additional coverage for previous accident years, the additional coverage is retroactive, even if the original coverage provided in the contract for those accident years was prospective. Likewise, if current losses under a multiple-year contract eliminate coverage in future periods, some or all of the premiums to be paid in those future periods should be charged to the current period.

26. Q: A reinsurance contract is entered into after the contract’s effective date. Is the coverage between the contract’s effective date and the date the contract was entered into prospective or retroactive?
A: The portion of the contract related to the period of time between the effective date of the contract and the date the contract was entered into is retroactive because it covers insured events that occurred prior to entering into the reinsurance contract.

27. Q: How is the date the reinsurance contract was entered into determined?

A: It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. For example, a contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place.

The absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the contract have not entered into a reinsurance contact, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date covered insurable events prior to that date, that coverage is retroactive.

In any event, SSAP No. 62R provides that if a contract (except facultative contracts and contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date, it is presumed to be retroactive.

28. Q: Are contracts to reinsure calendar-year incurred losses considered blended contracts that have both prospective and retroactive elements?

A: Yes. Most reinsurance contracts covering calendar-year incurred losses combine coverage for insured events that occurred prior to entering into the reinsurance contract with coverage for future insured events and, therefore, include both prospective and retroactive elements.

In any event, SSAP No. 62R provides that if a contract (except facultative contracts, contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date it is presumed retroactive.

29. Q: When the prospective and retroactive portions of a contract are being accounted for separately, how should premiums be allocated to each portion of the contract?

A: No specific method for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of a contract is required. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable.

Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If a reasonable basis for allocating the premiums between the prospective and retroactive coverage does not exist, the entire contract must be accounted for as a retroactive contract.

30. Q: A retroactive reinsurance contract contains a cut-through provision that provides the ceding entity’s policyholders and claimants with the right to recover their claims directly from the reinsurer. May the ceding entity immediately recognize earned surplus associated with this type of contract?
A: No. SSAP No. 622R states that earned surplus may not be recognized “until the actual retroactive reinsurance recovered exceeds the consideration paid.”

31. Q: A ceding entity enters into a retroactive reinsurance agreement that gives rise to segregated surplus. If the reinsurer prepays its obligation under the contract, may the ceding entity recognize earned surplus at the time the prepayment is received?

A: Segregated surplus arising from retroactive reinsurance transactions is earned as actual liabilities that have been transferred are recovered or terminated. Therefore, earned surplus is based on when the reinsurer settles its obligations to the ceding entity, and it may be appropriate to recognize earned surplus at the time the prepayment is received.

However, all of the facts and circumstances must be considered to determine whether the ceding entity has substantively recovered the liabilities transferred to the reinsurer. For example, if the ceding entity agrees to compensate the reinsurer for the prepayment, such as by crediting the reinsurer with investment income on prepaid amounts or balances held, the ceding entity has not, in substance, recovered its transferred liabilities but rather has received a deposit from the reinsurer that should be accounted for accordingly.

32. Q: If the ceding entity does not expect to receive any recoveries because the reinsurer has agreed to reimburse claimants under the reinsured contracts directly, would the ceding entity be considered to have recovered or terminated its transferred liabilities?

A: No. In the example given, the reinsurer is substantively acting as disbursing agent for the ceding entity. Therefore, the ceding entity cannot be said to have recovered amounts due from the reinsurer before payment is made to the claimant.

33. Q: What accounting entries would a ceding entity make to report a retroactive reinsurance contract?

A: Accounting Entries for a Ceding Entity to Report a Retroactive Reinsurance Contract:

Entry 1

Retroactive Reinsurance Reserves
Ceded or Assumed (B/S) 10,000
Retroactive Reinsurance Gain (I/S) 2,000
Cash 8,000

To record initial portfolio transfer see items #3 and #8. The ceding entity must establish the segregated surplus per item #4.

Entry 1A

Retro. Reins. Gain 2,000
Profit/Loss Account 2,000

To close gain from retroactive transaction.

Entry 1B

Profit/Loss Account 2,000
Special Surplus from Retro. Reins. 2,000

To close profit from retroactive reinsurance to special surplus.

Entry 2

Cash 2,000
Retroactive Reinsurance Reserves 2,000
Ceded or Assumed (B/S)
To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $8,000, and special surplus from retroactive reinsurance account equals $2,000; therefore, segregated surplus account is not changed per item #10.

**Entry 3**

Retroactive Reinsurance Reserves
Ceded or Assumed (B/S) 3,000
Retroactive Reinsurance Gain (I/S) 3,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is increased to $5,000 as a result of this upward development.

**Entry 3A**

Retro. Reinsurance Gain 3,000
Profit/Loss Account 3,000

To close profit from retroactive reinsurance.

**Entry 3B**

Profit/Loss (I/S) 3,000
Special Surplus from Retro. Reins. 3,000

To close profit and loss account to special surplus. (Retroactive reinsurance reserves ceded or assumed account balance equals $11,000. Special Surplus from retroactive reinsurance balance equals $5,000.)

**Entry 4**

Cash 4,000
Retroactive Reinsurance Reserves
Ceded or Assumed (B/S) 4,000

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $7,000, therefore segregated surplus account is not changed per item #10.

**Entry 5**

Cash 3,000
Retroactive Reinsurance Reserves
Ceded or Assumed (B/S) 3,000

To record recovery of paid losses from reinsurer. Outstanding ceded reserves after recovery equals $4,000, therefore the following entry is needed per items #6 and #10.

**Entry 5A**

Special Surplus—Retro. Reins. 1,000
Unassigned Funds 1,000

Retroactive Reinsurance reserves ceded or assumed after this entry equals $4,000.

**Entry 6**

Retroactive Reinsurance Loss (I/S) 1,000
Retroactive Reinsurance Reserves
Ceded or Assumed (B/S) 1,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is decreased as a result of this downward development to $3,000. The following entry is needed per items #6 and #10.
Entry 6A

Profit/Loss Account 1,000
Retro. Reins. Loss 1,000

To close loss to profit and loss account.

Entry 6B

Special Surplus from Retro. Reins. 1,000
Profit/Loss Account 1,000

To close profit and loss account to special surplus. (Remaining balance of retroactive reinsurance reserve ceded or assumed account equals $3,000.) (Special surplus from retro. reins. account balance equals $3,000.)

Entry 7

Cash 2,500
Retroactive Reinsurance Gain (I/S) 500
Retroactive Reinsurance Reserves Ceded or Assumed (B/S) 3,000

Entry 7A

Profit and Loss Account 500
Retro. Reins. Gain 500
To close other income to profit and loss account.

Entry 7B

Special Surplus from Retro. Reins. 500
Profit/Loss Account 500
To close profit and loss account to special surplus. (Remaining balance of special surplus from retro. reins. account equals $2,500.) (Remaining balance of retroactive reinsurance reserve ceded or assumed account -0-.)

Entry 7C

Special Surplus from Retro. Reins. 2,500
Unassigned Funds 2,500
To close remaining special surplus account to unassigned surplus.

34. Q: How should the parties account for an adverse loss development reinsurance contract where, as of the statement date, the attachment level of the contract exceeds the ceding company’s current case and IBNR reserves for the covered accident years (i.e. no surplus gain and no reinsurance recoverable as of the statement date), and the ceding company transferred cash to the reinsurer at the inception of the contract?

A: An adverse loss development reinsurance contract covering prior accident years meets the definition of “retroactive reinsurance” set forth in paragraph 22 of SSAP No. 62R:

…the reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance….
Subparagraph 29.k. of SSAP No. 62R specifically provides that the consideration paid for a retroactive reinsurance contract is to be recorded as a decrease in ledger assets by the ceding entity and an increase in ledger assets by the assuming entity.

Question 33 illustrates the accounting entries for retroactive reinsurance contracts.

If the retroactive reinsurance contract transfers both components of insurance risk then, pursuant to paragraph 29 of SSAP No. 62R, the ceding company would record the consideration paid as a decrease in ledger assets, recognize an expense for the reinsurance ceded through Other Income or Loss accounts as a write-in item identified as “Retroactive Reinsurance Ceded”, and record the recoverable from the reinsurer as a contra liability.

No contra liability is established until and unless (and then only to the extent that) the ceding company establishes reserves which exceed the attachment point.

For the contract described, at inception no contra liability is recorded to offset current liability for the business ceded, since the ceded retroactive reinsurance premium relates to coverage in excess of the current liabilities recorded by the ceding company.

Once the ceding company’s recorded liabilities exceed the attachment point of the adverse loss development reinsurance contract and triggers reinsurance recoverable from the reinsurer, a contra liability is established by the ceding company for the amount of the reinsurance recoverable. Any surplus resulting from the retroactive reinsurance is carried as a write-in item on the balance sheet designated as “Special Surplus from Retroactive Reinsurance Account.” The surplus gain may not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid.

If any portion of a retroactive reinsurance contract does not transfer insurance risk, then the portion which does not transfer risk is accounted for as a deposit pursuant to paragraph 35 of SSAP No. 62R. The deposit is reported as an admitted asset of the ceding company if the reinsurer is licensed, accredited or otherwise qualified in the ceding company’s state of domicile as described in Appendix A-785, or if there are funds held by or on behalf of the ceding company as described in that appendix. Receipts and disbursements under the contract are recorded through the deposit/liability accounts. Amounts received in excess of the deposit made are recognized as a gain in the Other Income or Loss account.

Accounting entries for a ceding entity to report a retroactive reinsurance contract at the inception of which the cedent’s reserves are lower than the attachment point of the reinsurance coverage:

Assume the company pays $16m to purchase adverse development coverage of $50m, above an attachment point.
Entry 1: Payment of Retrospective Reinsurance Premium

Retrospective Reinsurance Expense* $16m
Cash $16m

The company pays $16m premium for the retrospective reinsurance contract.
*This is an Other Expense item, it does not flow through Schedule F or Schedule P.

Entry 2: Adverse Development Reaches the Attachment Point

Losses Incurred $25m
Gross Loss Reserve $25m
Recoverable on Retro Reinsurance Contract** $25m
Other Income* $9m
Contra – Retro Reinsurance Expense* $16m
Surplus*** $9m
Segregated Surplus*** $9m

The company incurs $25m development on reserves related to the contract.
*These are Other Income/Expense items do not flow through Schedule F or Schedule P.
**A contra-liability write-in item, not netted against loss reserves.
***Surplus is segregated in the amount of [$25m - $16m = $9m] recoverables less consideration paid.

Entry 3: Cash is Recovered on Paid Losses

Cash $20m
Recoverable on Retrospective Reinsurance Contract $20m
Segregated Surplus $4m
Surplus $4m

The company recovers $20m cash from reinsurer on this retro contract. Segregated Surplus decreases in the amount of [$20m - $16m = $4m] (decreases for amount recovered in excess of consideration paid).

35. Q: How should a ceding company account for payment of the premium for a retroactive reinsurance contract by the ceding company’s parent company or some other person not a party to the reinsurance contract (for example, adverse loss development reinsurance contracts purchased by the parent company in the context of the purchase or sale of the ceding company)?

A: If the reinsurance premium is not paid directly by the ceding company but is instead paid on behalf of the ceding company by the ceding company’s parent company or some other entity not a party to the reinsurance contract, then the ceding company should (1) record an increase in gross paid in and contributed surplus in the amount of the reinsurance premium to reflect the contribution to surplus by the parent or third party payor, and (2) record an expense in the amount of the reinsurance premium and account for the contract as provided in Questions 33 and 34.
SSAP NO. 62R—EXHIBIT B

P&C Runoff Reinsurance Transactions

The following provides illustrative journal entries for P&C Runoff Reinsurance Transactions.

**Example 1:** Transfer of existing block of runoff business with no residual UPR on books of Transferor

<table>
<thead>
<tr>
<th>Cedent/Transferor</th>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Day 1 - Cedent transfers 50,000 in reserves for 50,000</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ceded Reinsurance Recoverable (U&amp;I Part 2A &amp; Sch. F)</td>
<td>Contra Liab ↑</td>
<td>50,000</td>
</tr>
<tr>
<td>____ Cash</td>
<td>Asset ↓</td>
<td>50,000</td>
</tr>
<tr>
<td>Losses Paid (U/W Part 2 &amp; Sch. P)</td>
<td>I/S ↓</td>
<td>50,000</td>
</tr>
<tr>
<td>____ Change in Reserves - Incurred Losses (U&amp;I Part 2)</td>
<td>I/S ↑</td>
<td>50,000</td>
</tr>
</tbody>
</table>

*Unlike novation – gross reserves stay on books of transferor*

| **Day 360 - Negative Development on Transferred Business - 3,000:** | | |
| Reserves for Unpaid Losses (U&I Part 2A & Sch. P) | Liab ↑ | 3,000 |
| ____ Reinsurance Recoverable on Unpaid Losses (Sche. F) | Contra Liab ↑ | 3,000 |

| **Day 540 – Reinsurer Pays the Loss @ Reported Reserve** | | |
| Reserves for Unpaid Losses (U&I Part 2A & Sch. P) | Liab ↓ | 53,000 |
| ____ Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F) | Contra Liab ↓ | 53,000 |

| Reinsurer/Transferee | | |
| **Day 1 - Cedent transfers 50,000 in reserves for 50,000** | | |
| Cash | Asset ↑ | 50,000 |
| ____ Reported Losses on Reins. Assumed (U&I Part 2A & Sch. P) | Liab ↑ | 50,000 |
| Change In Reserves – Incurred Losses (U&I Part 2) | I/S ↓ | 50,000 |
| ____ Losses Paid or Incurred (negative) (U&I Part 2 & Sch. P) | I/S ↑ | 50,000 |

| **Day 360 - Negative Development on Transferred Business - 3,000:** | | |
| Change in Reserves – Incurred Losses (U&I Part 2) | I/S ↓ | 3,000 |
| ____ Reserves for Unpaid Losses (U&I Part 2A & Sch. P) | Liab ↑ | 3,000 |

| **Day 540 – Reinsurer Pays the Loss** | | |
| Reserves for Unpaid Losses (U&I Part 2A & Sch. P) | Liab ↓ | 53,000 |
| ____ Cash | Asset ↓ | 53,000 |

**Comments:**

Since the Transferor is ceding incurred losses neither party should have premium impacted. To do that would distort many financial ratios.
**Example 2:** Transfer of existing block of runoff business with some residual UPR of 10,000 on books of Transferor (this should be less common).

<table>
<thead>
<tr>
<th>Cedent/Transferor</th>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day 1 - Cedent transfers 50k in reserves &amp; 10k UPR for 60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ceded Reinsurance Recoverable (U&amp;I Part 2A &amp; Sch. F)</td>
<td>Contra Liab</td>
<td>50,000</td>
</tr>
<tr>
<td>UNEARNED PREMIUM RESERVE (U&amp;I Part 1 &amp; 1A)</td>
<td>Liab ↓</td>
<td>10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>Asset ↓</td>
<td>60,000</td>
</tr>
<tr>
<td>Ceded Premium Written (U&amp;I Part 1B)</td>
<td>I/S ↓</td>
<td>10,000</td>
</tr>
<tr>
<td>Losses Paid (U&amp;I Part 2 &amp; Sch. P)</td>
<td>I/S ↓</td>
<td>50,000</td>
</tr>
<tr>
<td>Change in Reserves - Incurred Losses (U&amp;I Part 2.)</td>
<td>I/S ↑</td>
<td>50,000</td>
</tr>
<tr>
<td>Change in UPR (U&amp;I Part 1 &amp; 1A)</td>
<td>I/S ↑</td>
<td>10,000</td>
</tr>
</tbody>
</table>

*Unlike novation – gross reserves stay on books of transferor*

Day 180 – Premium is Fully Earned (Assumes 80% Loss Ratio)

| Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F) | Contra Liab | 8,000 |
| Reserves for Unpaid Losses (U&I Part 2A & Sch. P) | Liab ↑ | 8,000 |

*To mirror the increase in unpaid losses by the transferee*

Day 360 - Negative Development on Transferred Business -3,000:

| Reinsurance Recoverable on Unpaid Losses (Sch. F) | Contra Liab | 3,000 |
| Reserves for Unpaid Losses (U&I Part 2A & Sch. P) | Liab ↑ | 3,000 |

Day 540 – Reinsurer Pays the Loss @ Reported Reserves (50+8+3)

| Reserves for Unpaid Losses (U&I Part 2A & Sch. P) | Liab ↓ | 61,000 |
| Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F) | Contra Liab | 61,000 |
### Reinsurer/ Transferee

<table>
<thead>
<tr>
<th>Event</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day 1 - Cedent transfers 50k in reserves &amp; 10k UPR for 60,000</td>
<td>Cash</td>
<td>Asset ↑ 60,000</td>
<td>Liab ↑ 50,000</td>
</tr>
<tr>
<td></td>
<td>Reported Losses on Reins. Assumed (U&amp;I Part 2A &amp; Sch. P)</td>
<td>Liab ↑ 50,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Unearned Premium Reserve (U&amp;I Part 1 &amp; 1A)</td>
<td>Liab ↑ 10,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assumed Premium Written (U&amp;I Part 1B)</td>
<td>I/S ↑ 10,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Change In Reserves – Incurred Losses (U&amp;I Part 2)</td>
<td>I/S ↓ 50,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Change in UPR (U&amp;I Part 1 &amp; 1A)</td>
<td>I/S ↓ 10,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Losses Paid or Incurred (negative) (U&amp;I Part 2 &amp; Sch. P)</td>
<td>I/S ↑ 50,000</td>
<td></td>
</tr>
<tr>
<td>Day 180 – Premium is Fully Earned (Assumes 80% Loss Ratio)</td>
<td>Unearned Premium Reserve (U&amp;I Part 1 &amp; 1A)</td>
<td>Liab ↓ 10,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reserves for Unpaid Losses (U&amp;I Part 2A &amp; Sch. P)</td>
<td>Liab ↑ 8,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Change in Reserves – Incurred Losses (U&amp;I Part 2)</td>
<td>I/S ↓ 8,000</td>
<td></td>
</tr>
<tr>
<td></td>
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<td>I/S ↑ 10,000</td>
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<td></td>
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<tr>
<td>Day 360 - Negative Development on Transferred Business -3,000</td>
<td>Change in Reserves – Incurred Losses (U&amp;I Part 2)</td>
<td>I/S ↓ 3,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reserves for Unpaid Losses (U&amp;I Part 2A &amp; Sch. P)</td>
<td>Liab ↑ 3,000</td>
<td></td>
</tr>
<tr>
<td>Day 540 – Reinsurer Pays the Loss @ Reported Reserves (50+8+3)</td>
<td>Reserves for Unpaid Losses (U&amp;I Part 2A &amp; Sch. P)</td>
<td>Liab ↓ 61,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>Asset ↓ 61,000</td>
<td></td>
</tr>
</tbody>
</table>

**Comments:**
In this second example, the portion of the runoff business that has an UPR associated with it is essentially booked as prospective reinsurance. Other elements of the example are the same except that we assumed an 80% loss ratio on the unearned portion of the business.
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Statutory Issue Paper No. 138

Fair Value Measurements

STATUS:
Finalized Sept. 21, 2009

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. In September 2006, the Financial Accounting Standards Board (FASB) issued FAS 157, *Fair Value Measurements* (FAS 157) to define fair value, establish a framework for measuring fair value in generally accepted accounting principles (GAAP) and to expand disclosures about fair value measurements. Since the issuance of FAS 157, the FASB has issued four FASB staff positions (FSPs) and one EITF to provide clarification of the guidance under FAS 157.

   a. **FSP FAS 157-1:** Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13 (FSP FAS 157-1). This FSP revised FAS 157 to exclude accounting pronouncements that address lease accounting. This FSP identifies that the term fair value will be used differently under *FAS 13, Accounting for Leases,* (FAS 13) than under FAS 157.

   b. **FSP FAS 157-2:** Effective Date of FASB Statement No. 157 (FSP FAS 157-2). This FSP defers the effective date of FAS 157 for nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008.

   c. **FSP FAS 157-3:** Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active (FSP FAS 157-3). This FSP initially clarified the application of FAS 157 for a market that is not active and provided an illustration in determining the fair value of a financial asset when the market for that financial asset is not active. With the issuance of FSP FAS 157-4, FSP FAS 157-3 was superseded, thus all of the amendments to FAS 157 from this FSP were deleted or amended.

   d. **FSP FAS 157-4:** Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transaction That Are Not Orderly (FSP FAS 157-4). This FSP provides guidance for estimating fair value in accordance with FAS 157 when the volume and level of activity for the asset and liability have significantly decreased. This FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly.

   e. **EITF Issue No. 08-5, Issuer’s Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement** (EITF 08-5). This EITF provides guidance in determining an issuer’s unit of accounting for a liability issued with an inseparable third-party credit enhancement when it is measured or disclosed at fair value on a recurring basis. As noted within this EITF, the issuer of a liability with a third-party credit enhancement that is inseparable from the liability shall not include the effect of the credit enhancement in the fair value measurement of the liability. For example, in determining the fair value of debt with a third-party guarantee, the issuer would consider its own
credit standing and not that of the third-party guarantor. The issuer should disclose the existence of the third-party credit enhancement.

2. This issue paper proposes adoption, with modification, of FAS 157, FSP FAS 157-1 and FSP FAS 157-4. As components of FSP FAS 157-4 have been incorporated within INT 09-04, with the issuance of a final SSAP on fair value measurements INT 09-04 will be nullified. Guidance within FSP FAS 157-2 on the effective date for nonfinancial assets and nonfinancial liabilities is not considered applicable for statutory accounting, as the effective date of a new SSAP on fair value measurements will be after the effective date established by FSP FAS 157-2. FSP FAS 157-3 is considered rejected for statutory accounting purposes as the modifications made to FAS 157 from the issuance of that FSP have been amended or deleted with the issuance of FSP FAS 157-4. EITF 08-5 is considered rejected for statutory accounting purposes as the concept of considering non-performance risk (own credit risk) is inconsistent with the statutory accounting concept of conservatism and the assessment of financial solvency for insurers. Liabilities reported at fair value shall reflect the guidance adopted within FAS 157, as provided within this issue paper, without consideration of own-performance risk and without reflection of any third-party guarantee.

3. Current statutory accounting guidance for the definition of “fair value” is primarily located within the Glossary to the Accounting Practices and Procedures Manual. There are instances throughout the Statements of Statutory Principles (SSAPs) in which guidance on the definition of fair value is located within a specific SSAP. It is intended that all statutory references to “fair value” will be defined in accordance with the provisions established within this issue paper, except where specifically excluded.

Summary Conclusion

4. This issue paper defines fair value, establishes a framework for measuring fair value in statutory accounting principles, and expands disclosures about fair value measurements. This issue paper applies under other accounting pronouncements that require or permit fair value measurements, but this issue paper does not require any new fair value amendments. However, the application of this issue paper may change current practice. This issue paper does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this issue paper.

Scope

5. This issue paper applies under other statutory accounting pronouncements that require or permit fair value measurements, except as follows

a. This issue paper does not eliminate the practicality exceptions to fair value measurements in accounting pronouncements within the scope of this issue paper.

b. This issue paper does not apply under SSAP No. 22—Leases (SSAP No. 22) and other accounting pronouncements that address fair value measurements for purposes of lease classification to measurement under SSAP No. 22. This scope exception does not apply to assets acquired or liabilities assumed in a business combination that are required to be measured at fair value under SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68), regardless of whether those assets and liabilities are related to leases.

Definition of Fair Value

6. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Components of the Fair Value Definition

7. **Asset/Liability** - A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business).

8. **Price** - A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

9. **Principal (or Most Advantageous) Market** - A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s). In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

10. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

11. **Market Participants** - Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:
   
   a. Independent of the reporting entity; that is, they are not related parties;

   b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary;
c. Able to transact for the asset or liability; and

d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

12. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the asset or liability, and (c) market participants with whom the reporting entity would transact in that market.

13. **Application to Assets** - A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

14. The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:

a. **In-use** - The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, that might be the case for certain nonfinancial assets. If the highest and best use of the asset is in-use, the fair value of the asset shall be measured using an in-use valuation premise. When using an in-use valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those assets would be available to market participants. Generally, assumptions about the highest and best use of the asset should be consistent for all of the assets of the group within which it would be used.

b. **In-exchange** - The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, that might be the case for a financial asset. If the highest and best use of the asset is in-exchange, the fair value of the asset shall be measured using an in-exchange valuation premise. When using an in-exchange valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset standalone.

15. Because the highest and best use of the asset is determined based on its use by market participants, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.

16. **Application to Liabilities** - Consideration of non-performance risk (own credit-risk) should not be reflected in the fair value calculation for liabilities (including derivative liabilities) at subsequent measurement. At initial recognition, it is perceived that the consideration of own-credit risk may be inherent in the contractual negotiations resulting in the liability. The consideration of non-performance risk for subsequent measurement is inconsistent with the conservatism and recognition concepts as well as the assessment of financial solvency for insurers, as a decrease in credit standing would effectively
decrease reported liabilities and thus seemingly increase the appearance of solvency. Furthermore, liabilities reported or disclosed at “fair value” shall not reflect any third-party credit guarantee of debt.

**Fair Value at Initial Recognition**

17. When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

18. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

   a. The transaction is between related parties.

   b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

   c. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

   d. For liabilities, differences may exist as non-performance risk (own credit risk) is not reflected in the fair value (i.e., exit price) determination of all liabilities (including derivatives).

**Valuation Techniques**

19. Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value. Key aspects of those approaches are summarized below:

   a. Market approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark quoted securities.
b. Income approach. The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

c. Cost approach. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

20. Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

21. Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate pursuant to SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3). The disclosure provisions of SSAP No. 3 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

Inputs to Valuation Techniques

22. In this issue paper, inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk, for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable:

a. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.

b. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.
Valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs.

**Fair Value Hierarchy**

23. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

24. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

**Level 1 Inputs**

25. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 26 and 27.

26. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

27. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

28. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.
Level 2 Inputs

29. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

   a. Quoted prices for similar assets or liabilities in active markets
   b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)
   c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
   d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

30. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

31. The reporting entity should evaluate the following factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability (or similar assets or liabilities). The factors include, but are not limited to:

   a. There are few recent transactions.
   b. Price quotations are not based on current information.
   c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).
   d. Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
   e. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity’s estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.
   f. There is a wide bid-ask spread or significant increase in the bid-ask spread.
g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.

h. Little information is released publicly (for example, a principal-to-principal market).

The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

32. If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with this issue paper. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

33. This issue paper does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. Paragraphs 19-21 discuss the use of valuation techniques in estimating fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, the reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

34. Even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, the reporting entity’s intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.

35. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate that a transaction is not orderly include, but are not limited to:

a. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

c. The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).
d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

The reporting entity shall evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

36. The determination of whether a transaction is orderly (or not orderly) is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. Accordingly, the reporting entity shall consider the following guidance:

a. If the weight of the evidence indicates the transaction is not orderly, the reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.

b. If the weight of the evidence indicates the transaction is orderly, the reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.

c. If the reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall consider that transaction price when estimating fair value or market risk premiums. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). The reporting entity shall place less weight on transactions on which the reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.

In its determinations, the reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction.

37. Regardless of the valuation technique(s) used, the reporting entity shall include appropriate risk adjustments. Risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment. Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.

38. When estimating fair value, this issue paper does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the reporting entity has determined that the quoted prices provided by those parties are determined in accordance with this issue paper. However, when there has been a significant decrease in the Volume or level of activity for the asset or liability, the reporting entity should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, the reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of
the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

Level 3 Inputs

39. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

Inputs Based on Bid and Ask Prices

40. If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). This issue paper does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

Disclosures

41. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (for example, common stock), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements and for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period separately for each major category of assets and liabilities (for equity and debt securities), major category shall be defined as major security type:

a. The fair value measurements at the reporting date and the source of the fair value measurement. (Source of fair value measurement is only required in annual audited reporting periods.)

b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

c. For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:
(1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities).

(2) Purchases, sales, issuances, and settlements (net).

(3) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs).

d. The amount of the total gains or losses for the period in subparagraph (c) (1) above included in earnings (or changes in net assets) that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income (or activities).

e. The inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

42. For assets and liabilities that are measured at fair value on a nonrecurring basis in periods subsequent to initial recognition (for example, impaired assets), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period separately for each major category of assets and liabilities (for equity and debt securities major category shall be defined as major security type):

a. The fair value measurements recorded during the period and the reasons for the measurements.

b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3).

c. For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs.

d. The inputs and valuation technique(s) used to measure fair value and a discussion of changes, if any, in the valuation technique(s) and related inputs used to measure similar assets and/or liabilities in prior periods.

43. The quantitative disclosures required by this issue paper shall be presented using a tabular format. (See Exhibit A.)

44. The reporting entity is encouraged, but not required, to combine the fair value information disclosed under this issue paper with the fair value information disclosed under other accounting pronouncements (for example, disclosures about fair value of financial instruments) in the periods in which those disclosures are required, if practicable. The reporting entity also is encouraged, but not required, to disclose information about other similar measurements, if practicable.
Disclosures about Fair Value of Financial Instruments (Copied from SSAP No. 27 and modified to reflect adoption of FSP FAS 107-1 and APB 28-1. This modification would require disclosures for annual and quarter financial statements.)

45. A reporting entity shall disclose in the notes to the financial statements, as of each date for which a statement of financial position is presented in the quarterly or annual financial statements, the aggregate 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 identified in paragraph 46. 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. Unless specified otherwise in another SSAP, 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.

46. The disclosures about fair value prescribed in paragraph 45 are not required for the following:

a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in SSAP No. 12—Employee Stock Ownership Plans (SSAP No. 12), Stock Options and Stock Purchase Plans (SSAP No. 13), SSAP No. 14—Postretirement Benefits Other Than Pensions (SSAP No. 14), and SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8 (SSAP No. 89).

b. Substantively extinguished debt subject to the disclosure requirements of SSAP No. 91R—Accounting for Transfer and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R).

c. Insurance contracts, other than financial guarantees and deposit-type contracts

d. Lease contracts as defined in SSAP No. 22—Leases (SSAP No. 22).

e. Warranty obligations and rights.

f. Investments accounted for under the equity method.

g. Equity instruments issued by the entity.

47. 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; and

b. The reasons why it is not practicable to estimate fair value.

48. 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.

Relevant Literature

49. This issue paper adopts with modification FAS 157, Fair Value Measurements; (FAS 157) FSP
FAS 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting
Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or
Measurement Under Statement 13, (FSP FAS 157-1) and FSP FAS 157-4, Determining Fair Value When
the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying
Transactions That Are Not Orderly (FSP FAS 157-4). Modifications from FAS 157, FSP FAS 157-1 and
FSP FAS 157-4 include:

a. This issue paper does not adopt the scope exclusion within paragraph 2a of FAS 157
regarding share-based payment transactions. FASB Statement No. 123, Share-Based
Payment, and its related interpretive accounting pronouncements that address share-based
payment transactions are still being considered for statutory accounting. If these GAAP
standards are adopted for statutory accounting, consideration will be given to
incorporating an exclusion for determining fair value in accordance with the guidance
under this issue paper. This issue paper is considered applicable under SSAP No. 13—
Stock Options and Stock Purchase Plans (SSAP No. 13)

b. This issue paper does not adopt the scope exclusions within paragraph 3 of FAS 157 for
accounting pronouncements that require or permit measurements that are similar to fair
value but that are not intended to measure fair value, including (a) accounting
pronouncements that permit measurements that are based on, or otherwise use, vendor-
specific objective evidence of fair value and (b) inventory pricing. These items are
excluded as they are not prevalent within statutory accounting.

c. This issue paper does not adopt guidance from FAS 157 regarding the consideration of
non-performance risk (own credit risk) in determining the fair value measurement of
liabilities. The consideration of own credit-risk in the measurement of fair value
liabilities is inconsistent with the statutory accounting concept of conservatism and the
assessment of financial solvency for insurers. The fair value determination for liabilities
should follow the guidance adopted from FAS 157, with the exception of the
consideration of own-performance risk.

d. This issue paper includes revisions to reference statutory standards or terms instead of
GAAP standards or terms.

e. This issue paper incorporates the guidance from SSAP No. 27 regarding disclosures
about fair value of financial instruments. This incorporated SSAP No. 27 guidance was
adopted from FAS 107, Disclosures about Fair Value of Financial Instruments (FAS
107) and was revised to adopt FSP FAS 107-1 and APB-1, Interim Disclosures about
Fair Value of Financial Instruments (FSP FAS 107-1 and APB-1). For statutory
purposes, the incorporation of this guidance within one standard results in having one
comprehensive standard addressing fair value measurements and disclosures.
50. Paragraphs 42-44 adopt 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 and FASB Emerging Issues Task Force No. 85-20, Recognition of Fees for Guaranteeing a Loan. Financial instruments named within paragraph 8 of FAS 107 that are exempt from disclosure are adopted to the extent applicable for statutory accounting and are reflected in paragraph 46. This issue paper also adopts revisions to FAS 107 reflected in FSP FAS 107-1 and APB-1, Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1 and APB-1), and thus requires disclosure in both annual and quarterly financial statements. In addition, 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. FAS 119 is addressed in SSAP No. 31.

Effective Date and Transition

51. This issue paper shall be effective for December 31, 2010 annual financial statements, with interim and annual financial statement reporting thereafter. Early adoption is permitted for December 31, 2009 annual financial statements, with interim and annual reporting thereafter.
Exhibit A - Disclosure Illustrations:

52. Assets Measured at Fair Value on a Recurring Basis:

<table>
<thead>
<tr>
<th>(In millions)</th>
<th>Level 1</th>
<th>Level 2</th>
<th>Level 3</th>
<th>Total</th>
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<tbody>
<tr>
<td>Assets at fair value:</td>
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<tr>
<td>Preferred Stock</td>
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<td>Sub-Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Derivative Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Separate Account Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Assets at Fair Value</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities at Fair Value:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Derivatives Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Liabilities at Fair Value</td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

53. Assets Measured at Fair Value on a Recurring Basis Using Significant Unobservable Inputs (Level 3):

<table>
<thead>
<tr>
<th>(In millions)</th>
<th>Equity Securities</th>
<th>Separate Account Assets</th>
<th>Derivative Assets</th>
<th>Derivative Liabilities</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1/1/0X:</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Total Gains or Losses (realized/unrealized)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Included in net income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Included in surplus</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases, issuances and settlements</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transfers in (out) of Level 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance at 12/31/0X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total gains (losses) included in income attributable to instruments held at the reporting date</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td></td>
</tr>
</tbody>
</table>
54. **Assets Measured at Fair Value on a Nonrecurring Basis:**

<table>
<thead>
<tr>
<th>Description</th>
<th>12/31/0X</th>
<th>Quoted Prices in Active Markets for Identical Assets (Level 1)</th>
<th>Significant Other Observable Inputs (Level 2)</th>
<th>Significant Unobservable Inputs (Level 3)</th>
<th>Total Gains (Losses)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preferred Stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**DISCUSSION:**

55. In considering FAS 157 for statutory accounting, the Statutory Accounting Principles Working Group agreed that a consistent definition of fair value should be established to address inconsistencies that may exist on the definition and application of fair value within individual statements of statutory accounting principles. Furthermore, the Working Group agreed that the statutory definition and application of fair value should be similar to the GAAP definition of fair value to minimize situations in which “fair value” is calculated differently between GAAP and SAP. By having similar fair value definitions, it is presumed that assets reported at fair value will not vary between GAAP and SAP financial statements. As illustrated within this issue paper, for determining the fair value of liabilities, the concept of considering own credit risk has been rejected for statutory accounting. Thus, it is presumed that in some instances fair value measurements under GAAP and SAP for liabilities will differ.

**Modifications to Generally Accepted Accounting Principles**

56. This issue paper does not incorporate the GAAP concept of “unit of account”. This GAAP concept reflects the application of the fair value measurement guidance to assets or liabilities that are based in groups or lots. Statutory accounting has not previously endorsed the concept of “unit of account” as the statutory measurement of financial instruments is calculated in accordance with single securities. Thus, this term has not been reflected within the statutory accounting fair value measurement guidance.

57. This issue paper does not adopt the scope exclusion within paragraph 2a of FAS 157 regarding share-based payment transactions. *FASB Statement No. 123R, Share-Based Payment*, and its related interpretive accounting pronouncements that address share-based payment transactions are still being considered for statutory accounting. If these GAAP standards are adopted for statutory accounting, consideration will be given to incorporating an exclusion for determining fair value in accordance with the guidance under this issue paper. This issue paper is considered applicable under *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13).

58. This issue paper does not adopt the scope exclusions within paragraph 3 of FAS 157 for accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value, including (a) accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value and (b) inventory pricing. These items are excluded as they are not prevalent within statutory accounting.

59. This issue paper does not adopt guidance from FAS 157 regarding the consideration of non-performance risk (own credit risk) in determining the fair value measurement of liabilities. The consideration of own credit-risk in the measurement of fair value liabilities is inconsistent with the statutory accounting concept of conservatism and the assessment of financial solvency for insurers. The fair value determination for liabilities should follow the guidance adopted from FAS 157, with the exception of the consideration of own-performance risk. This issue paper also rejects guidance within...
EITF 08-05, Issuer’s Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement (EITF 08-05). Thus, under statutory accounting, liabilities measured at fair value shall not include the issuer’s own credit risk, or reflect any third-party guarantee of debt. The consideration of non-performance risk is considered inconsistent with the recognition concept as protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. If statutory liabilities reflected the reporting entity’s non-performance risk, the balance sheet would ineffectively illustrate the financial condition of the insurer.

60. This issue paper includes revisions to reference statutory standards or terms instead of GAAP standards or terms.

61. This issue paper incorporates the guidance from SSAP No. 27 regarding disclosures about fair value of financial instruments. This incorporated SSAP No. 27 guidance was adopted from FAS 107, Disclosures about Fair Value of Financial Instruments (FAS 107) and was revised to adopt FSP FAS 107-1 and APB-1, Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1 and APB-1). For statutory purposes, the incorporation of this guidance within one standard results in having one comprehensive standard addressing fair value measurements and disclosures.

Modifications to Statutory Accounting Principles

62. This issue paper proposes the establishment of a singular standard to define fair value, establish a framework for measuring fair value and to address disclosures about fair value measurements. In order to implement a single standard for fair value guidance, with the adoption of the final standard the following corresponding modifications will be incorporated within existing statutory accounting guidance: (Appendix A illustrates these statutory accounting modifications.)

a. SSAP No. 2—Cash, Drafts, and Short-Term Investments (SSAP No. 2) – Reference to SSAP No. 27 in paragraph 13a will be deleted, and replaced with reference to the SSAP on fair value measurements.

b. SSAP No. 13—Stock Options and Stock Purchase Plans (SSAP No. 13) – Paragraph 8 will be deleted with the issuance of the fair value measurements SSAP. (FAS 157 does not apply under any pronouncements that address share-based payment transactions. Thus deleting paragraph 8 may be considered inconsistent with GAAP as references to fair value in this standard would inherently follow the guidance in the new SSAP. However, the determination of fair value currently included within paragraph 8 of SSAP No. 13 does not appear to contradict with the fair value definition proposed within this issue paper.) Reference to market price in paragraphs 3d, 6 and 14 will be revised to reflect fair value.

c. SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities (SSAP No. 26) - Reference to SSAP No. 27 in paragraph 17a will be replaced with reference to the new SSAP on fair value measurements. Paragraph 4 will be revised to remove the phrase “which cannot exceed the fair value at the date of acquisition”. Retention of this phrase would result with a difference between GAAP and SAP if FAS 157 is adopted, as proposed within this issue paper, for statutory accounting.

d. SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27) – Paragraphs 8-10 and 13-14 will be deleted with the issuance of the fair value measurements standard. Furthermore, all references to fair value disclosures included throughout the standard (including the title) and the reference to adopted FAS 107 GAAP guidance will be deleted. All fair
value disclosure requirements, including financial instruments disclosures, and references to adopted GAAP guidance pertaining to fair value will be incorporated within the new SSAP on fair value measurements. (SSAP No. 27 will be retained for the other items addressed within this standard.) The modification proposed is a variation from GAAP as FAS 107 still includes fair value disclosure requirements for financial instruments. However, this issue paper concludes that the paragraphs currently included within SSAP No. 27 for statutory financial instrument disclosures would be more appropriately placed, and improve the ease of application, if included in the new SSAP on fair value measurements.

e. **SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)** (SSAP No. 30) – Reference to SSAP No. 27 in paragraphs 13d and 13f will be revised to reference the new SSAP on fair value measurements. Paragraph 5 will be revised to remove the sentence “Cost shall not exceed fair value.” Retention of this sentence would result with a difference between GAAP and SAP if FAS 157 is adopted, as proposed within this issue paper, for statutory accounting. In accordance with FAS 157, transaction costs would be initially included in ‘cost’ at acquisition. For subsequent reporting, unrealized gains/losses would be reflected to illustrate the difference between the acquisition cost and fair value. If the existing SSAP No. 30, paragraph 5 guidance was retained for statutory accounting, the initial recognition of the asset would have an immediate unrecognized loss (assumed to represent transaction costs if purchased at fair value). As at subsequent reporting, the GAAP and SAP valuation of the asset would both reflect fair value, and as transaction costs are typically immaterial, the existing variation from GAAP seems to generate an operational difference between GAAP and SAP that would not provide a significant impact to capital and surplus for statutory purposes.

f. **SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled or affiliated entities)** (SSAP No. 32) - Reference to SSAP No. 27 in paragraphs 29a and 29f will be revised to reference the new SSAP on fair value measurements. Paragraph 10 will be revised to remove the sentence “Cost shall not exceed fair value.” Retention of this sentence would result with a difference between GAAP and SAP if FAS 157 is adopted, as proposed within this issue paper, for statutory accounting. In accordance with FAS 157, transaction costs would be initially included in ‘cost’ at acquisition. For subsequent reporting, unrealized gains/losses would be reflected to illustrate the difference between the acquisition cost and fair value. If the existing SSAP No. 32, paragraph 10 guidance was retained for statutory accounting, the initial recognition of the asset would have an immediate unrecognized loss (assumed to represent transaction costs if purchased at fair value). As at subsequent reporting, the GAAP and SAP valuation of the asset would both reflect fair value, and as transaction costs are typically immaterial, the existing variation from GAAP seems to generate an operational difference between GAAP and SAP that would not provide a significant impact to capital and surplus for statutory purposes.

g. **SSAP No. 36—Troubled Debt Restructuring** (SSAP No. 36) – Revisions are incorporated to paragraphs 10 and 11to clarify the determination of fair value in accordance with the new SSAP on fair value measurements.

h. **SSAP No. 37—Mortgage Loans** (SSAP No. 37) - Reference to SSAP No. 27 in paragraph 20a will be revised to reference the new SSAP on fair value measurements.

i. **SSAP No. 40—Real Estate Investments** (SSAP No. 40) – Guidance in paragraph 11 for the regarding the definition of fair value will be deleted, but the requirement to obtain an
appraisal if market quotes are unavailable will be retained. Reference to “market value” in paragraphs 19, 20 and 24b will be deleted and replaced with the term “fair value”.

j. **SSAP No. 43R—Loan-Backed and Structured Securities-Revised (SSAP No. 43R)** – Reference to SSAP No. 27 in paragraph 48 will be revised to reference the new SSAP on fair value measurements. Paragraph 7 will be revised to remove the sentence “Cost shall not exceed fair value.” Retention of this sentence would result with a difference between GAAP and SAP if FAS 157 is adopted, as proposed within this issue paper, for statutory accounting. In accordance with FAS 157, transaction costs would be initially included in ‘cost’ at acquisition. For subsequent reporting, unrealized gains/losses would be reflected to illustrate the difference between the acquisition cost and fair value. If the existing SSAP No. 43, paragraph 6 guidance was retained for statutory accounting, the initial recognition of the asset would have an immediate unrecognized loss (assumed to represent transaction costs if purchased at fair value). As at subsequent reporting, the GAAP and SAP valuation of the asset would both reflect fair value, and as transaction costs are typically immaterial, the existing variation from GAAP seems to generate an operational difference between GAAP and SAP that would not provide a significant impact to capital and surplus for statutory purposes.

k. **SSAP No. 51—Life Contracts (SSAP No. 51)** – The term “market value” included within paragraphs 38a.iii and 38a.iv. will be revised to refer to “fair value”.

l. **SSAP No. 52—Deposit-Type Contracts (SSAP No. 52)** – The term “market value” included within paragraphs 17a.iii and 17a.iv will be revised to refer to “fair value”.

m. **SSAP No. 56—Separate Accounts (SSAP No. 56)** – The term “market value” included within paragraphs 17, 18, 18a, 20, 22, 26, 31b, 32 and 41 will be revised to refer to “fair value”. The use of the term “market value adjusted contracted” as illustrated in paragraphs 20 and 29c will be retained.

n. **SSAP No. 61—Life, Deposit-Type and Accident and Health Reinsurance (SSAP No. 61)** – The term “market value” included within paragraphs 55, 59a.iii and 59a.iv will be revised to refer to “fair value”. The term “market-value adjustments” included within paragraph 59a will be retained.

o. **SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvement in Health Care Facilities (SSAP No. 73)** – The reference to “market” in paragraph 5 will be revised to refer to “fair value”.

p. **SSAP No. 74—Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer Through a Protected Cell (SSAP No. 74)** – In the glossary to this statement, the term “fair value” will be redefined to reference the new SSAP on fair value measurements.

q. **SSAP No. 86—Accounting for Derivatives, Instruments and Hedging Activities (SSAP No. 86)** – Reference to SSAP No. 27 in paragraph 14 will be revised to reflect the new SSAP No. 27 title (as modified pursuant to the inclusion of all fair value disclosures within the new SSAP on fair value measurements). Throughout SSAP No. 86, Exhibit C, the term “marked-to-market” will be deleted.

r. **SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments (SSAP No. 90)** – Reference to the definition of fair value included within the Glossary to
the AP&P manual in paragraphs 16 and 41d will be revised to refer to the new SSAP on fair value measurements. Additionally, the term “market price” in paragraph 5a will be replaced with the term “fair value”.

s. **SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities** (SSAP No. 91R) – Paragraph 7e will be revised to eliminate the reference to the glossary and instead reference the new SSAP on fair value measurements. Paragraphs 8 and 12 will be revised to remove the parenthetical definition of fair value “presumably, the price paid”. Paragraphs 95f.i and 95g.i will be revised to remove the parenthetical instruction on determining fair value and be revised to reference the new SSAP on fair value measurements. The Glossary to SSAP No. 91R will revise the definition of “Derivative Financial Instrument” to update the title of SSAP No. 27 pursuant to the revisions adopted by the new SSAP on fair value measurements.

t. **SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments** (SSAP No. 93) – References to “market value” in paragraphs 1c, 1d, 5 and 20b will be revised to refer to “fair value”.

u. **SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions** (SSAP No. 95) – Revisions will be incorporated to paragraph 14 to define fair value in accordance with the new SSAP on fair value measurements. (No revisions will be incorporated to paragraph 7, as the ‘fair value’ is based on the measurement method used for each type of asset pursuant to SSAP that provides guidance for that asset type. If the SSAP was to prescribe a fair value measurement, then the new SSAP on fair value measurements would be utilized.)

v. **SSAP No. 97—Insurance in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88** (SSAP No. 97) – Reference to “market” in 31a will be revised to refer to “fair value”. Reference to “quoted market price” in 31b, will be revised to refer to “quoted price”.

w. **Glossary to the Statements of the Statutory Accounting Principles** (Glossary) – The definition of fair value will be revised to refer to the new SSAP on fair value measurements.

x. **INT 99-17: EITF 97-12: Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan Under APB Opinion No. 25** (INT 99-17) – Consistent with the proposed revisions to SSAP No. 13, the term “market” in paragraph 2 will be revised to reflect “fair value.”

y. **INT 99-29: Classification of Step-Up Preferred Stock** (INT 99-29) – The reference to “market” in paragraph 4 will be revised to reflect “fair value”.

z. **INT 01-14: EITF 00-16: Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation** (INT 01-14) – The reference to “market value” in paragraph 1 will be revised to reflect “fair value”. (The reference to “market sectors” within that paragraph will be retained.)

aa. **INT 01-31: Assets Pledged as Collateral** (INT 01-31) – The reference to “market value” in paragraph 6 will be revised to reflect “fair value”.

bb. **INT 02-05: Accounting for Zero Coupon Convertible Bonds** (INT 02-05) – The reference to “marked to market” within paragraph 3 will be revised to reflect “fair value”. Also in
paragraph 3, the term “market” in the last paragraph will be revised to reflect “fair value”. In paragraph 4, the statement “Mark AFS and Trading to market” will be revised to read “Mark AFS and Trading to fair value”.

cc. INT 03-03: Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee when a Qualified Opinion is Provided (INT 03-03) – Reference to “market value” in paragraph 2 will be revised to reflect “fair value”.

dd. INT 04-07: EITF 02-15: Determining Whether Certain Conversations of Convertible Debt to Equity Securities Are Within the Scope of FASB Statement No. 84 (INT 04-07) – The term “fair market value” throughout paragraph 4 will be revised to reflect “fair value”.

ee. INT 06-07: Definition of Phrase “Other Than Temporary” (INT 06-07) – The reference to the definition of fair value within the Glossary will be revised to reflect the new SSAP on fair value measurements.

ff. INT 09-04, Application of the Fair Value Definition (INT 09-04) – This interpretation will be nullified with the issuance of this standard. (As this item will be completely nullified, this item has not been included within Appendix A.)

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

63. Statutory accounting guidance for the definition of fair value is primarily included within the Glossary to Statutory Accounting Principles. In limited situations the definition of fair value is further defined within individual SSAPs, but the guidance within the Glossary is the underlying guidance for the previous definition of fair value within statutory accounting statements:

Fair Value - The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified.
objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

64. The guidance incorporated within the Glossary was previously established from GAAP guidance in paragraph 13 of FAS 15, Accounting for Debtors (FAS 15). (This guidance has been superseded by FAS 157):

13 …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.

65. The adoption of a new SSAP, that adopts, with modification, FAS 157 to define fair value, establish a framework for measuring fair value in generally accepted accounting principles (GAAP) and to expand disclosures about fair value measurements will result with continued fair value measurements that are essentially identical for statutory and GAAP purposes. Furthermore, developing a specific statement to address fair value will address the need to have consistent and comparable guidance throughout the SSAPs.

66. The adoption, with modification, of FAS 157 will change the statutory approach to determining fair value. With the guidance proposed under this issue paper, the transaction to sell an asset or liability, and determine fair value, is a hypothetical transaction at the measurement date considered from the perspective of a market participant that holds the asset or owes the liability. Thus, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

67. By adopting, with modification, FAS 157, statutory accounting principles will incorporate the following key aspects of FAS 157:

a. Fair value is a market-based measurement, not an entity-specific measurement. Thus, fair value measurements shall be determined based on the assumptions that market participants would use in pricing the asset or liability.

b. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity’s own assumptions about market participant assumptions based on the best information available in the circumstances (unobservable inputs).

c. Market participant assumptions include assumptions about risk. A fair value measurement should include an adjustment for risk if market participants would include one in pricing the related asset or liability, even if the adjustment is difficult to determine. Therefore, a measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.
Generally Accepted Accounting Principles

68. The GAAP guidance for the fair value measurements is included within FAS 157, as modified by FSP FAS 157-1, FSP FAS 157-2 and FSP FAS 157-4: (Note: FSP FAS 157-3 is not reflected in the amended FAS 157, as the modifications included within FSP FAS 157-4 deleted all revisions originally incorporated by FSP FAS 157-3.)

1. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Where applicable, this Statement simplifies and codifies related guidance within generally accepted accounting principles (GAAP).

Scope

2. This Statement applies under other accounting pronouncements that require or permit fair value measurements, except as follows:

   a. This Statement does not apply under accounting pronouncements that address share-based payment transactions: FASB Statement No. 123 (revised 2004), Share-Based Payment, and its related interpretive accounting pronouncements that address share-based payment transactions.

   b. This Statement does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this Statement.

   c. This Statement does not apply under FASB Statement No. 13, Accounting for Leases, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13. This scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under Statement 141 or Statement 141(R), regardless of whether those assets and liabilities are related to leases.

3. This Statement does not apply under accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value, including the following:

   a. Accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value

   b. ARB No. 43, Chapter 4, "Inventory Pricing."

4. Appendix D lists pronouncements of the Accounting Principles Board (APB) and the FASB existing at the date of this Statement that are within the scope of this Statement. Appendix E lists those APB and FASB pronouncements that are amended by this Statement.

Measurement

Definition of Fair Value

5. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The Asset or Liability

6. A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for
example, an asset group, a reporting unit, or a business). Whether the asset or liability is a standalone asset or liability or a group of assets and/or liabilities depends on its unit of account. The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes of applying other accounting pronouncements. The unit of account for the asset or liability should be determined in accordance with the provisions of other accounting pronouncements, except as provided in paragraph 27.

The Price

7. A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

The Principal (or Most Advantageous) Market

8. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s). In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

9. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

Market Participants

10. Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

a. Independent of the reporting entity; that is, they are not related parties

b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary
c. Able to transact for the asset or liability

d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

11. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the asset or liability, and (c) market participants with whom the reporting entity would transact in that market.

Application to Assets

12. A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

13. The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:

a. In-use. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, that might be the case for certain nonfinancial assets. If the highest and best use of the asset is in-use, the fair value of the asset shall be measured using an in-use valuation premise. When using an in-use valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those assets would be available to market participants. Generally, assumptions about the highest and best use of the asset should be consistent for all of the assets of the group within which it would be used.

b. In-exchange. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, that might be the case for a financial asset. If the highest and best use of the asset is in-exchange, the fair value of the asset shall be measured using an in-exchange valuation premise. When using an in-exchange valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset standalone.

14. Because the highest and best use of the asset is determined based on its use by market participants, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.

Application to Liabilities

15. A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled) and that the nonperformance risk relating to that liability is the same before and after its transfer. Nonperformance risk refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. Therefore, the fair value of the liability shall reflect the nonperformance risk relating to that liability. Nonperformance risk includes but may not be limited to the reporting entity's own credit risk. The reporting entity shall consider the effect of its credit risk on the fair value of the liability.
risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value. That effect may differ depending on the liability, for example, whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a nonfinancial liability), and the terms of credit enhancements related to the liability, if any.

**Fair Value at Initial Recognition**

16. When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

17. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

   a. The transaction is between related parties.
   b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.
   c. The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.
   d. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

**Valuation Techniques**

18. Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value. Key aspects of those approaches are summarized below:

   a. Market approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark quoted securities.
b. Income approach. The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

c. Cost approach. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

19. Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

20. Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, Accounting Changes and Error Corrections, paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

Inputs to Valuation Techniques
21. In this Statement, inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk, for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable:

a. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.

b. Unobservable inputs are inputs that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.
Valuation techniques used to measure fair value shall maximize the use of relevant observable inputs (that is Level 1 and Level 2 inputs that do not require significant adjustment) and minimize the use of unobservable inputs.

*Fair Value Hierarchy*

22. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

23. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

*Level 1 Inputs*

24. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 25 and 26.

25. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

26. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

27. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

*Level 2 Inputs*

28. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a
specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active. (Paragraph 29A includes example factors that may indicate that a market is not active or that there has been a significant decrease in the volume and level of activity for the asset or liability when compared to normal market activity for the asset or liability (or similar assets or liabilities), depending on the degree to which the factors exist.)

c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

29. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

29A. The reporting entity should evaluate the following factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities). The factors include, but are not limited to:

a. There are few recent transactions.

b. Price quotations are not based on current information.

c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).

d. Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

e. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity’s estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.

f. There is a wide bid-ask spread or significant increase in the bid-ask spread.

g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.

h. Little information is released publicly (for example, a principal-to-principal market).
The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

29B. If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with this Statement. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

29C. This Statement does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. Paragraphs 18–20 discuss the use of valuation techniques in estimating fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, the reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

29D. Even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, the reporting entity’s intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.

29E. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate that a transaction is not orderly include, but are not limited to:

   a. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

   b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

   c. The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).

   d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.
The reporting entity shall evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

29F. The determination of whether a transaction is orderly (or not orderly) is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. Accordingly, the reporting entity shall consider the following guidance:

a. If the weight of the evidence indicates the transaction is not orderly, the reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.

b. If the weight of the evidence indicates the transaction is orderly, the reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.

c. If the reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall consider that transaction price when estimating fair value. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). The reporting entity shall place less weight on transactions on which the reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.

In its determinations, the reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction.

29G. Regardless of the valuation technique(s) used, the reporting entity shall include appropriate risk adjustments. Paragraph B5 of this Statement indicates that “risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment.” Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.

29H. When estimating fair value, this Statement does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the reporting entity has determined that the quoted prices provided by those parties are determined in accordance with this Statement. However, when there has been a significant decrease in the Volume or level of activity for the asset or liability, the reporting entity should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, the reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.
Level 3 Inputs

30. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

Inputs Based on Bid and Ask Prices

31. If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). This Statement does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

Disclosures

32. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (for example, trading securities), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements and for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period separately for each major category of assets and liabilities (for equity and debt securities major category shall be defined as major category type as described in paragraph 19 of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities even if the equity securities or debt securities are not within the scope of Statement 115):

a. The fair value measurements at the reporting date

b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

c. For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:

(1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities)

(2) Purchases, sales, issuances, and settlements (net)
(3) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

d. The amount of the total gains or losses for the period in subparagraph (c)(1) above included in earnings (or changes in net assets) that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income (or activities)

e. The inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

33. For assets and liabilities that are measured at fair value on a nonrecurring basis in periods subsequent to initial recognition (for example, impaired assets), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period separately for each major category of assets and liabilities (for equity and debt securities major category shall be defined as major category type as described in paragraph 19 of Statement 115 even if the equity securities or debt securities are not within the scope of Statement 115):

a. The fair value measurements recorded during the period and the reasons for the measurements

b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

c. For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs

d. The inputs and valuation technique(s) used to measure fair value and a discussion of changes, if any, in the valuation technique(s) and related inputs used to measure similar assets and/or liabilities in prior periods.

34. The quantitative disclosures required by this Statement shall be presented using a tabular format.

35. The reporting entity is encouraged, but not required, to combine the fair value information disclosed under this Statement with the fair value information disclosed under other accounting pronouncements (for example, FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments) in the periods in which those disclosures are required, if practicable. The reporting entity also is encouraged, but not required, to disclose information about other similar measurements (for example, inventories measured at market value under ARB 43, Chapter 4), if practicable.

Effective Date and Transition

36. Except as provided in subparagraphs 36(a) and 36(b) below, this Statement shall be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year.

a. Delayed application of this Statement is permitted for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair
value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

b. An entity that has issued interim or annual financial statements reflecting the application of the measurement and disclosure provisions of this Statement prior to the issuance of FSP FAS 157-2, Effective Date of FASB Statement No. 157, must continue to apply all of the provisions of this Statement.

37. This Statement shall be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except as follows. This Statement shall be applied retrospectively to the following financial instruments as of the beginning of the fiscal year in which this Statement is initially applied (a limited form of retrospective application):

   a. A position in a financial instrument that trades in an active market held by a broker-dealer or investment company within the scope of the AICPA Audit and Accounting Guides for those industries that was measured at fair value using a blockage factor prior to initial application of this Statement

   b. A financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in footnote 3 of EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," prior to initial application of this Statement

   c. A hybrid financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in Statement 133 (added by FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments) prior to initial application of this Statement.

38. At the date this Statement is initially applied to the financial instruments in paragraph 37(a)–(c), a difference between the carrying amounts and the fair values of those instruments shall be recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The disclosure requirements of Statement 154 for a change in accounting principle do not apply.

39. The disclosure requirements of this Statement (paragraphs 32–35), including those disclosures that are required in annual periods only, shall be applied in the first interim period of the fiscal year in which this Statement is initially applied. The disclosure requirements of this Statement need not be applied for financial statements for periods presented prior to initial application of this Statement.
Appendix A - Illustrations of Modifications to Statutory Accounting Guidance:

**SSAP No. 2—Cash, Drafts and Short-Term Investments:**

13. The following disclosures shall be made for short-term investments in the financial statements:
   a. Fair values in accordance with SSAP No. 100—Fair Value Measurements, SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27);

**SSAP No. 13—Stock Options and Stock Purchase Plans:**

3. A reporting entity recognizes no compensation expense for services received in return for stock issued through noncompensatory plans. The following four characteristics are essential in a noncompensatory plan:
   d. The discount from the market price (or fair value) of the stock is no greater than would be reasonable in an offer of stock to stockholders or others.

6. The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (a) the number of shares that an individual employee is entitled to receive and (b) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after the date of grant or award. Thus, a reporting entity recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price (or fair value) of the stock at the measurement date.

8. Quoted market prices in active markets are the best evidence of fair value and shall be used as fair value, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances.

14. Compensation expense related to stock appreciation rights and other variable stock option or award plans shall be measured at the end of each period as the amount by which the quoted market price (or value, if not available) of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market price (or value, if not available) should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

**SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities:**

4. 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 value at the date of acquisition.

17. The financial statements shall include the following disclosures:
   a. Fair values disclosures in accordance with SSAP No. 100—Fair Value Measurements, SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27).
SSAP No. 138

8. A reporting entity shall disclose in the notes to the financial statements the aggregate 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, Disclosures about Fair Value of Financial Instruments (FAS 107). 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 SSAP, 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.

9. 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 quoted market prices are not 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).

10. 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; and
   b. The reasons why it is not practicable to estimate fair value.

13. This statement 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 and FASB Emerging Issues Task Force No. 85-20, Recognition of Fees for Guaranteeing a Loan. In addition, this statement rejects FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107. FAS 119 is addressed in SSAP No. 31.

14. Paragraph 8 of FAS 107 discusses financial instruments which are exempt from fair value disclosure. Included as exempt instruments are insurance contracts, except for financial guaranty contracts.

SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)

5. At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. Cost shall not exceed fair value. Common stock acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

13. The following disclosures regarding common stocks shall be made in the financial statements:

   d. The disclosures in (i) and (ii) above should be segregated by those common stocks that have been in a continuous unrealized loss position for less than 12
months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27—Fair Value Measurements.

f. When it is not practicable to estimate fair value in accordance with SSAP No. 27, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)

10. At acquisition, preferred stock shall be reported at cost, including brokerage and other related fees. Cost shall not exceed fair value. PIK stock received as dividends shall be recorded at fair value. Acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

29. The following disclosures regarding preferred stocks shall be made in the financial statements:

a. Fair values in accordance with SSAP No. 100—Fair Value Measurements; SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27);

f. The disclosures in (i) and (ii) above should be segregated by those preferred stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27—Fair Value Measurements.

h. When it is not practicable to estimate fair value in accordance with SSAP No. 27, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

SSAP No. 36—Troubled Debt Restructuring

10. 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 restructuring involving the transfer of assets shall be accounted for at the fair value of the assets received. Troubled debt restructuring 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 NAIC Purposes and Procedures of the Securities Valuation Office (SVO Purposes and Procedures)) in accordance with SSAP No. 100—Fair Value Measurements. 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 with SSAP No. 100 (reference new SSAP). 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. After the troubled debt restructuring, a creditor shall account for the assets consistent with the statutory guidance for such assets.

11. 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.

SSAP No. 37—Mortgage Loans

20. The following disclosures shall be made in the financial statements:

a. Fair values in accordance with SSAP No. 100—Fair Value Measurement; SSAP No. 27—Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27); SSAP No. 40—Real Estate Investments

11. 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; and

e. Replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).

19. A participating mortgage loan is established when the lender is entitled to participate in appreciation of the market value, fair value of mortgaged real estate, the results of operations of the mortgaged real estate project, or in both. Mortgage loan participation features should be recorded at fair value at inception of the loan. The borrower should recognize a participation liability for the determined fair valued amount, with a corresponding debit to a debt discount account. The debt discount should be amortized by the interest method, using the effective interest rate. After inception, adjustment of the participation liability should occur at each reporting date to current fair value. The corresponding debit or credit should be to the related debt discount account. The revised debt discount should be amortized prospectively, using the effective interest rate method.
20. The real estate investment with the participating mortgage loan should be reported in accordance with paragraph 4, with no adjustment for appreciation of \textit{market value}. \\

24. An entity that holds real estate investments with participating mortgage loan features should disclose: \\
a. Aggregate amount of participating mortgage obligations at the balance-sheet date, with separate disclosure of the aggregate participation liabilities and related debt discounts. \\
b. Terms of participations by the lender in either the appreciation in the \textit{market value} of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or both. \\

\textit{SSAP No. 43R—Loan-Backed and Structured Securities - Revised} \\

6. At acquisition, loan-backed securities, except for loan-backed or structured securities that are beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount\textsuperscript{1} (see paragraphs 20 through 24), shall be reported at cost, including brokerage and related fees. \textit{Cost shall not exceed \textit{fair value}.} Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts. \\

48. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed securities shall be made in the financial statements: \\
a. Fair values in accordance with \textit{SSAP No. 100—Fair Value Measurements}. \textit{SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27)}; \\
i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with \textit{SSAP No. 27SSAP No. 100}. \\
k. When it is not practicable to estimate \textit{fair value} in accordance with \textit{SSAP No. 27}, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements: \\
i. The aggregate carrying value of the investments not evaluated for impairment, and \\
ii. The circumstances that may have a significant adverse effect on the fair value. \\

\textit{SSAP No. 51—Life Contracts} \\

38. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows: \\
a. Subject to discretionary withdrawal: \\
iii. \textit{At market \textit{fair value}}, where the withdrawal of funds is payable at current market \textit{fair value} of the assets supporting the liabilities, the assets are stated at current market \textit{fair value}, and the liabilities are stated at the current market \textit{fair value} or per unit value of the \\

\textsuperscript{1} As referenced in the Relevant Literature section, this Statement adopts EITF 99-20, including the scope requirements of that guidance.
assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at market fair value;

SSAP No. 52—Deposit-Type Contracts

17. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:

iii. At market fair value, where the withdrawal of funds is payable at current market fair value of the assets supporting the liabilities, the assets are stated at current market fair value, and the liabilities are stated at the current market fair 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 fair value;

SSAP No. 56—Separate Accounts

17. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at market fair value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

18. An AVR is generally required for separate accounts when the insurer, rather than the policyholder/contractholder, suffers the loss in the event of asset default or market fair value loss. An AVR is required unless:

a. The asset default or market fair value risk is borne directly by the policyholders; or

20. Assets supporting typical modified guaranteed contracts, market value adjusted contracts, and contracts with book value guarantees similar to contracts generally found in the general account do require an AVR because the insurer is responsible for credit related asset or market fair value loss.

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

26. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at market fair value). Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

31. For each risk-based capital grouping (as detailed in paragraph 32), the following shall be disclosed:

a. Premiums, considerations or deposits received during the year;
b. Reserves by the valuation basis of the investments supporting the reserves at the financial statement date. List reserves for separate accounts whose assets are carried at market fair value separately from those whose assets are carried at amortized cost/book value;

c. Reserves by withdrawal characteristics, i.e., whether or not the separate account is subject to discretionary withdrawal or market value adjustment, or to withdrawal at book value with or without surrender charge;

32. For the disclosures required in paragraph 31, separate accounts shall be addressed in the following groupings (which are the same as those used for risk-based capital):

b. Nonguaranteed Separate Accounts-Variable separate accounts, where the benefit is determined by the performance and/or market fair value of the investments held in the separate account. Include variable accounts with incidental risks, nominal expense, and minimum death benefit guarantees.

41. This statement is effective for years beginning January 1, 2001. Contracts with assets held in a Separate Account that were issued in accordance with applicable state laws and regulations and issued prior to that effective date, for which assets and liabilities have been recorded using a consistent basis since issue, i.e., both assets and liabilities are recorded either as if in the general account ("book value") or as at market fair value (current interest rates based on market rates shall be used for liabilities when assets are recorded at market fair value), shall continue to be recorded using such basis until such time as the applicable contract terms or provisions are substantially changed, such as by a contract amendment modifying interest rate or withdrawal provisions. State laws and regulations shall be understood to include anything considered authoritative by the domiciliary state under the individual state's statutory authority and due process procedures. Changes that do not require change in the basis of recording would include: address changes, continued deposits, and other non-substantive changes such as these. For example, additional funds received after January 1, 2001 under contracts issued prior to January 1, 2001 may continue to be recorded using the basis in effect prior to January 1, 2001 until such time as a triggering change is made. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

SSAP No. 61—Life, Deposit-Type and Accident and Health Reinsurance

55. The assuming entity is to value the assets acquired at the date of acquisition at their market fair values, and the reserves are to be established according to statutory requirements based on the benefits in the individual policies reinsured. If the liabilities exceed the assets, the difference represents goodwill that must be amortized into operations using the interest method over the life of the policies, but for a period not to exceed 10 years. Goodwill resulting from assumption reinsurance transactions shall be included in the total goodwill of an entity when calculating the amount of goodwill that is a nonadmitted asset pursuant to SSAP No. 68—Business Combinations and Goodwill. If the assets exceed the liabilities, the assuming entity shall record a deferred liability and amortize the amount into operations using the interest method over the expected life of the business but not to exceed ten years.

59. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:

iii. At market fair 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 fair value, and the liabilities are stated at the current market fair 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 fair value;

SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities

5. The reporting entity shall maintain a control system that provides for identification of quantities on hand and appropriate valuation (lower of cost or market fair value) of supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

SSAP No. 74—Accounting for Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell

Glossary:

Fair value - See GLOSSARY to the Statements of Statutory Accounting Principles SSAP No. 100—Fair Value Measurements.

SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions (Note – 106 hits of ‘fair’ and 15 hits of ‘market’)

14. Derivative instruments represent rights or obligations that meet the definitions of assets (SSAP No. 4—Assets and Nonadmitted Assets) or liabilities (SSAP No. 5) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, and Disclosures about Fair Value of Financial Instruments (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 8 through 10 of SSAP No. 27. Derivative instruments are admitted assets to the extent they conform to the requirements of this statement.

Exhibit C – SSAP No. 86

1.b.i.(e) - If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or the designated portion of the derivative shall be valued at its current fair value (marked to market) with gains and losses recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

1.b.ii(a) - Options, warrants, caps, or floors purchased or written shall be valued at current fair value (marked to market) with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus).

1.b.iii. - Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: options, warrants, caps, or floors purchased or written shall be valued at current fair value (marked to market) with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.

1.b.iii.(b) - If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative or the designated portion of the derivative shall continue to be valued at its current fair value (marked to market), but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

2.b.i.(5) - If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or a designated
portion of the derivative shall be valued at its current fair value (marked to market) with gains and losses recorded in unrealized gains or unrealized losses to the extent that it ceased to be an effective hedge. Upon redesignation into an effective hedging relationship, the derivative’s mark to fair value through unrealized gain or loss shall be reversed.

2.b.ii(a) - Swaps, collars, or forwards shall be valued at current fair value (marked to market) with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

2.b.iv. - Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: swaps, collars and forwards shall be valued at current fair value (marked to market) with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.

(a) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative shall continue to be valued at its current fair value (marked to market), but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

iv. Open futures hedging items recorded at fair value, where gains and losses on the hedging item are recognized currently in earnings shall be valued at current fair value (marked to market) with changes in fair value recognized currently in earnings.

SSAP No. 90—Accounting for the Impairment of Disposal of Real Estate Investments

5. A long-lived asset shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

a. A significant decrease in the market price

Fair Value

16. A discussion of fair value is contained in the Glossary to the Statements of Statutory Accounting Principles SSAP No. 100—Fair Value Measurement. This statement requires properties occupied by the company, that are determined to be subject to recoverability testing as discussed in paragraphs 6 and 7, to follow the guidance in SSAP No. 40, paragraph 11.

41. The modifications to FAS 144 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts:

d. Paragraphs 22 through 24 which discuss fair value, are rejected. The definition of fair value is in SSAP No. 100—Fair Value Measurements, the glossary to the Statement of Statutory Accounting Principles. In addition, this statement allows a modification to use for determining the fair value of properties occupied by company.

SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

7. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 5), the transferor (seller) shall:

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see Glossary to the Statements of Statutory Accounting Principles SSAP No. 100—Fair Value Measurements), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 49); and

8. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).
12. If distinct servicing rights exist in accordance with the above guidelines, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. Servicing assets and servicing liabilities shall be measured initially at fair value, presumptively the price paid. Servicing assets or liabilities shall be measured subsequently at fair value at each reporting date with fluctuations in fair value reported as unrealized gains and losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses. shall be amortized into income in proportion to, and over the period of estimated servicing income.

95. A reporting entity shall disclose the following:

f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the interests that continue to be held by a transferor, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value. (Fair value shall be determined in accordance with SSAP No. 100—Fair Value Measurements (Glossary to the Statements of Statutory Accounting Principles); and

Glossary: Derivative financial instrument - A derivative instrument (as defined in SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions) that is a financial instrument (refer to SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, and Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments, paragraph 2).

SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments

1. This statement establishes statutory accounting principles for investments in federal and certain state sponsored Low Income Housing Tax Credit (LIHTC) properties. State sponsored LIHTC programs that have the following characteristics are within the scope of and shall be accounted for in accordance with this statement:

- Resale value of the investment is not based upon the market value/fair value of the underlying real estate.

- Market value/Fair value of the investment is directly tied to the remaining stream of tax credits and deductible losses.
5. Resale valuation of these investments is based on the present value of the future stream of tax credits and deductible losses, and not the market value/fair value of the underlying real estate.

20. 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 investment in a LIHTC. If in the aggregate the LIHTC investments exceed 10% of the total admitted assets of the reporting entity the following disclosures shall be made:

b. For partnerships, and limited liability companies for which a quoted market price/fair value is available, the aggregate value of each partnership, or limited liability company investment based on the quoted market price/fair value; and

SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions

14. Fair value of a nonmonetary asset transferred to or from a reporting entity in a nonmonetary transaction should be determined in accordance with SSAP No. 100—Fair Value Measurements by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88

31. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, market-fair value or discounted market-fair 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;

Glossary to the Statements of Statutory Accounting Principles

Fair Value — Fair value is defined in SSAP No. 100—Fair Value Measurements. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.
If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimates based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

**Market Value** - Market value is equivalent to fair value.

**INT 99-17: EITF 97-12: Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25.**

2. The working group reached a consensus that EITF 97-12 should be adopted to require that additional shares granted in a stock purchase plan be classified as compensatory or noncompensatory at the grant date of the additional shares. If the discount at that date does not meet the market fair value discount criterion in paragraph 3(d) of SSAP No. 13, then the new grant would be treated as a compensatory award under SSAP No. 13, which would result in compensation cost.

**INT 99-29: Classification of Step-up Preferred Stock**

4. A strict reading of the perpetual preferred stock definition further complicates the issue in that step-ups do not have redemption features: thus, they meet the definition of perpetual preferred stock. The valuation of step-up preferred stock would not be consistent with the economic substance of the security if it were valued at market fair value.

**INT 01-14: EITF 00-16: Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation**

1. **Topic No. D-83, Accounting for Payroll Taxes Associated with Stock Option Exercises** requires that payroll taxes incurred in connection with stock-based compensation be recognized as an expense, but it does not address the timing of that expense recognition. Costs incurred by companies for employer payroll taxes on employee stock-based compensation have become more significant for U.S. companies as a result of the increased use of options as a form of employee compensation and the rapid growth in the market fair value of underlying stocks in certain market sectors. Consequently, the predominant current practice of recognizing those costs when the event that triggers payment to the taxing authority occurs (for an option, that event is employee exercise), has been called into question.
INT 01-31: Assets Pledged as Collateral

6. The working group reached a consensus that if the collateral had not been pledged in the examples described above, it is assumed the underlying asset would be recorded as an admitted asset under SSAP No. 4 (e.g. they are readily marketable assets available to meet both current and future policyholder obligations). In addition, it is assumed that the asset would not be considered impaired under SSAP No. 5 due to a default, market fair value decline, or other loss contingency.

INT 02-05: Accounting for Zero Coupon Convertible Bonds

3. A convertible bond really consists of a bond and an embedded derivative in the form of a warrant. Under GAAP, the holder accounts for the two components separately. The bond and warrants are fair valued at date of purchase. The bond is typically classified as available for sell (AFS) or held to maturity (HTM) and the scientific method of amortization is used on any premium or discount. This amortization of the premium or discount produces a market yield when combined with the coupon rate. In addition, the available for sale is marked to market recorded at fair value with the unrealized gains and losses recorded as a component of equity in other comprehensive income. The warrant is fair valued at each reporting date and classified as trading with the adjustments to market fair value recorded through the income statement, as it is considered a derivative (no hedge).

4. For GAAP, assuming a purchase price was $900,000 at 1/1/x1 and the fair value of the warrants was $150,000 at 1/1/x1, the following entries would be recorded during the year:

At 1/1/X1:
- Purchase Price $900,000
- Bond Fair Value $750,000
- Yield 8.87%
- Warrant Fair Value $150,000

At 12/31/X1:
- Bond Fair Value $780,000
- Warrant Fair Value $200,000

Entries 1/1/X1:
- Bonds-AFS $750,000
- Warrants-Trading $150,000
- Cash ($900,000)

Entries 12/31/X1:
- Cash (coupon rate) $50,000
- Bonds-AFS (amortization) $16,554
- Investment income ($66,554)

Record discount accretion and cash from coupon rate
- Bonds-AFS 13,446
- Warrants-Trading 50,000
- Unrealized gains-OCI (13,446)
- Realized gains (50,000)

Mark AFS and Trading to market fair value

INT 03-03: Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee When a Qualified Opinion is Provided

2. Certain situations may exist in which a qualified opinion is provided due to a GAAP departure, while information is available to determine the appropriate balances under a GAAP
basis of accounting. For example, a qualified opinion would be given if a cost sharing agreement requires the cost basis of accounting to be used to value investments in a limited partnership in which the reporting entity owned more than a 5% interest, as GAAP requires such investments to be recorded based upon the GAAP equity method. Since the notes to the financial statements disclose the market fair value of investments held by the limited partnership, information is readily available to allocate the unrealized appreciation on investments to determine what the appropriate GAAP equity balance would be. A qualified opinion could also result if the unrealized appreciation on investments is not allocated in accordance with a partnership agreement. Another example occurs when a qualified opinion is issued due to a departure from GAAP and the departure is related to the valuation of an U.S. insurance entity on the basis of U.S. statutory accounting principles.

INT 04-07: EITF 02-15: Determining Whether Certain Conversions of Convertible Debt to Equity Securities Are Within the Scope of FASB Statement No. 84

3. The following is excerpted from EITF 02-15:

3. Statement 84 was issued to amend Opinion 26, to exclude from its scope convertible debt that is converted to equity securities of the debtor pursuant to conversion privileges different from those included in the terms of the debt at issuance, and the change in conversion privileges is effective for a limited period of time, involves additional consideration, and is made to induce conversion. That Statement applies only to conversions that both (a) occur pursuant to changed conversion privileges that are exercisable only for a limited period of time and (b) include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted. When convertible debt is converted to equity securities of the debtor pursuant to an inducement offer (described above), the debtor shall recognize an expense equal to the excess of the fair value of all securities and other consideration transferred in the transaction over the fair value of securities issuable pursuant to the original conversion terms.

4. A question has arisen as to whether Statement 84 applies to conversions of convertible debt when the "offer" for consideration in excess of the original conversion terms was made by the debt holder rather than the debtor. In certain circumstances, for example, a bondholder may be a third party that purchased the bonds in the open market (often at a significant discount from face value) and approached the debtor to increase the conversion terms of the notes. In many of those circumstances, the offer to induce conversion is not extended to all debt holders; rather, the conversion involves only the specific debt holder that approached the debtor. The following example is provided:

Company A issued publicly traded convertible bonds (the Bonds) during a prior period. Currently, the Bonds are trading at a price that is significantly less than the carrying value (possibly due to a decline in Company A's stock price or credit rating or both). The original conversion price of the Bonds is $50 (20 shares of common stock per bond), and Company A's common stock is currently trading at $25 per share. On an individual basis, bondholders approach Company A with an offer for Company A to purchase the Bonds by providing consideration in excess of the conversion terms. Assume that on the date of the exchange, each Bond has the following values:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A's carrying value of the Bonds</td>
<td>$1,000</td>
</tr>
<tr>
<td>Current fair market value of the Bonds</td>
<td>$750</td>
</tr>
</tbody>
</table>

A bondholder approaches Company A with the following two independent offers that are exercisable by Company A for a limited period of time:

1. Company A may purchase the Bonds in exchange for the Bonds' original conversion of 20 shares of Company A common stock ($500 fair market value) and $300 cash.
2. Company A may purchase the Bonds in exchange for 32 shares of Company A common stock ($800 fair market value).

INT 06-07: Definition of Phrase “Other Than Temporary”

2. The decision for determining when an investment is considered impaired is dictated by the applicable SSAP and the respective impairment indicators included in each of the SSAPs. If an impairment indicator is present, the determination of an impairment shall be assessed at the individual security or investment level as reported in the annual statement and supporting schedules. For those SSAPs that require the reporting entity to use the fair value to determine if an impairment has occurred, the determination of that value shall be consistent with how the term fair value is defined within the Glossary of the Accounting Practices and Procedures Manual SSAP No. 100—Fair Value Measurements. Once a reporting entity has determined that an impairment indicator is present, the reporting entity shall continue to evaluate whether the investment is impaired each subsequent reporting period until either (a) the investment experiences a recovery of the fair value up to (or beyond) its carrying value or (b) the investor recognizes an other-than-temporary impairment loss.
Statutory Issue Paper No. 140

Substantive Revisions to SSAP No. 43—Loan-Backed and Structured Securities

STATUS:
Adopted December 5, 2009

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to retain for historical purposes the statutory guidance superseded with the issuance of SSAP No. 43R—Loan-Backed and Structured Securities – Revised (SSAP No. 43R):

   a. SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 43);

   b. SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 98);

   c. Paragraph 13 of SSAP No. 99—Accounting for Certain Securities to an Other-Than-Temporary Impairment (SSAP No. 99)

2. This Issue Paper also details SSAP No. 43R as initially adopted in September 2009. The substantive revisions adopted within SSAP No. 43R include accounting guidance for securities acquired in a transfer, beneficial interests, recognition of impairment and disclosures.

3. SSAP No. 43R supersedes SSAP No. 98 (impairment to fair value) and revises valuation and impairment requirements based on the cash flows expected to be collected for the securities, rather than fair value. Since the impairment requirements are based upon expected cash flows, most impairment charges recognized will be based upon cash flows that the reporting entity does NOT expect to collect (credit related). Reporting entities would only impair to fair value if there is intent to sell the security, or the reporting entity cannot assert that they have the intent and ability to retain the investment for a period of time sufficient to recover the amortized cost basis. No. 43R provides differences in impairment recognition for situations when: 1) there is an intent to sell; 2) the entity does not have the intent and ability to hold the security; and 3) there is a non-interest related decline, when there is no intent to sell and when the entity has the intent and ability to hold the security.

4. For historical record, the guidance within SSAP No. 43, SSAP No. 98, and paragraph 13 of SSAP No. 99, which has been superseded by SSAP No. 43R, has been included as the ‘Relevant Statutory Accounting’ guidance within paragraphs 7, 8 and 9.

5. The adopted guidance within SSAP No. 43R has been included below:

   1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities. In accordance with SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R), retained beneficial interests from the sale of loan-backed securities and structured securities are
accounted for in accordance with this statement. In this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.

SUMMARY CONCLUSION

2. Loan-backed securities are 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.

3. Structured securities are 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.

4. Loan-backed securities 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 or other securities. Some sponsors do guarantee the performance of the underlying loans.

5. Loan-backed securities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

6. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:
   a. Loan-backed and structured securities acquired at origination,
   b. Loan-backed and structured securities acquired subsequent to origination for which it is probable, at acquisition, that the reporting entity will be able to collect all contractually required payments receivable, and are accounted for at acquisition under SSAP No. 91R,
   c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period1, that the reporting entity will be unable to collect all contractually required payments receivable, and
   d. Beneficial interests that continue to be held by a reporting entity (transferor) in securitization transactions that are accounted for as sales under SSAP No. 91R and purchased beneficial interests in securitized financial assets2.

7. At acquisition, loan-backed securities, except for loan-backed or structured securities that are beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount3 (see paragraphs 20 through 24), shall be reported at cost, including brokerage

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1 Securities classified within the type of paragraph 6.a. or 6.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

2 The accounting requirements related to these type of securities included in paragraphs 20 through 24 shall be determined at acquisition or initial transfer.

3 As referenced in the Relevant Literature section, this Statement adopts EITF 99-20, including the scope requirements of that guidance.
and related fees. Cost shall not exceed fair value. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.

8. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded 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 repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

9. Interest shall be accrued using the effective-yield method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income 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.

10. For reporting entities required to maintain an IMR, the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date and shall be reported as net realized capital gains or losses in the Statement of Income.

11. 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. These fees shall be reported as investment income when received.

Collection of All Contractual Cashflows is Probable

12. The following guidance applies to loan-backed and structured securities for which it is probable that the investor will be able to collect all contractually required payments receivable. (Paragraphs 17-19 provide guidance for securities in which collection of all contractual cash flows is not probable and paragraphs 20-24 provide guidance for beneficial interests.) Prepayments are a significant variable element in the cash flow of loan-backed securities 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 reporting entity to reinvest assets 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. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, which should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.

13. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall 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 each prepayment assumption shall be documented by the reporting entity.
14. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at anytime during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17 through 19.

15. 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 the prospective 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 security is determined to be other than temporarily impaired.

16. 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.

Collection of All Contractual Cashflows is Not Probable

17. The following guidance applies to loan-backed and structured securities with evidence of deterioration of credit quality since origination for which it is probable, either known at acquisition or identified during the holding period, that the investor will be unable to collect all contractually required payments receivable, except for those beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount determined at acquisition (see paragraphs 20 through 24).

18. The reporting entity shall recognize the excess of all cash flows expected at acquisition over the investor's initial investment in the loan-backed or structured security as interest income on an effective-yield basis over the life of the loan-backed or structured security (accretable yield). Any excess of contractually required cash flows over the cash flows expected to be collected is the nonaccretable difference. Expected prepayments shall be treated consistently for determining cash flows expected to be collected and projections of contractual cash flows such that the nonaccretable difference is not affected. Similarly, the difference between actual prepayments and expected prepayments shall not affect the nonaccretable difference.

19. An investor shall continue to estimate cash flows expected to be collected over the life of the loan-backed or structured security. If, upon subsequent evaluation:

a. The fair value of the loan-backed or structured security has declined below its amortized cost basis, an entity shall determine whether the decline is other than temporary. For example, if, based on current information and events, there is a decrease in cash flows expected to be collected (that is, the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph 19.b.), an other-than-temporary impairment shall be considered to have occurred. The investor shall consider both the timing and

A loan-backed or structured security may be acquired at a discount because of a change in credit quality or rate or both. When a loan-backed or structured security is acquired at a discount that relates, at least in part, to the security’s credit quality, the effective interest rate is the discount rate that equates the present value of the investor’s estimate of the security’s future cash flows with the purchase price of the loan-backed or structured security.
amount of cash flows expected to be collected in making a determination about whether there has been a decrease in cash flows expected to be collected.

b. Based on current information and events, if there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor shall recalculate the amount of accretable yield for the loan-backed or structured security as the excess of the revised cash flows expected to be collected over the sum of (1) the initial investment less (2) cash collected less (3) other-than-temporary impairments plus (4) amount of yield accreted to date. The investor shall adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment shall be accounted for as a change in estimate in conformity with SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3), with the amount of periodic accretion adjusted over the remaining life of the loan-backed or structured security (prospective method).

Beneficial Interests

20. The following paragraphs provide statutory accounting guidance for interest income and impairment for a reporting entity that continues to hold an interest in securitized financial assets accounted for as sales under SSAP No. 91R, or that purchases a beneficial interest in securitized financial assets that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount, determined at acquisition or the date of transfer. Beneficial interests that are of high credit quality and cannot contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded investment, shall be accounted for in accordance with paragraphs 12 through 16.

21. The reporting entity shall recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date (referred to herein as the transaction date) over the initial investment (the accretable yield) as interest income over the life of the beneficial interest using the effective yield method. If the holder of the beneficial interest is the reporting entity that transferred the financial assets for securitization, the initial investment would be the allocated carrying amount after application of the relative fair value allocation method required by SSAP No. 91R. The amount of accretable yield shall not be displayed in the balance sheet.

22. The reporting entity that holds a beneficial interest shall continue to update the estimate of cash flows over the life of the beneficial interest. If upon evaluation:

a. Based on current information and events it is probable that there is a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected, then the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of estimated cash flows over the beneficial interest’s reference amount (the reference amount is equal to (1) the initial investment less (2) cash received to date less (3) other-than-temporary impairments recognized to date [as described in paragraph 22(b)] plus (4) the yield accreted to date. The adjustment shall be accounted for prospectively as a change in estimate in conformity with SSAP No. 3, with the amount of periodic accretion adjusted over the remaining life of the beneficial interest. Based on estimated cash flows, interest income may be recognized on a beneficial interest even if the net investment in the beneficial interest is accreted to an amount greater than the amount at which the beneficial interest could be settled if prepaid immediately in its entirety.

5 The accounting requirements related to these type of securities included in paragraphs 20 through 24 shall be determined at acquisition or initial transfer. As referenced in the Relevant Literature section, this Statement adopts EITF 99-20, including the scope requirements of that guidance.
b. The fair value of the beneficial interest has declined below its reference amount; a reporting entity shall determine whether the decline is other-than-temporary. If, based on current information and events it is probable that there has been an adverse change in estimated cash flows (in accordance with paragraph 22(a) above), then (1) an other-than-temporary impairment shall be considered to have occurred and (2) the beneficial interest shall be written down to the current estimate of cash flows at the financial reporting date discounted at a rate equal to the current yield used to accrete the beneficial interest with the resulting change being recognized as a realized loss. Determining whether there has been a favorable (or an adverse) change in estimated cash flows involves comparing the present value of the remaining cash flows as estimated at the initial transaction date (or at the last date previously revised) against the present value of the cash flows estimated at the current financial reporting date. The cash flows shall be discounted at a rate equal to the current yield used to accrete the beneficial interest. If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is less than the present value of the current estimate of cash flows expected to be collected, the change is considered favorable (that is, an other-than-temporary impairment shall be considered to have not occurred). If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is greater than the present value of the current estimated cash flows, the change is considered adverse (that is, an other-than-temporary impairment shall be considered to have occurred). However, absent any other factors that indicate an other-than-temporary impairment has occurred, changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest generally shall not result in the recognition of an other-than-temporary impairment6 (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater).

23. All cash flows estimated at the transaction date are defined as the holder’s estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder’s fair value determination for purposes of determining a gain or loss under SSAP No. 91R. Subsequent to the transaction date, estimated cash flows are defined as the holder’s estimate of the amount and timing of estimated principal and interest cash flows based on the holder’s best estimate of current information and events. A change in estimated cash flows is considered in the context of both timing and amount of the estimated cash flows.

24. In situations in which it is not practicable for a transferor to estimate the fair value of the beneficial interest at the initial transfer date, interest income shall not be recognized using the interest method. For these beneficial interests (that is, those beneficial interests that continue to be held by a transferor that are recorded at $0 pursuant to SSAP No. 91R), the transferor shall use the cash basis for recognizing interest income because the beneficial interest will have an allocated carrying amount of zero.

Reporting and Impairment Guidance for All Loan-Backed and Structured Securities

25. Loan-backed securities shall be valued and reported in accordance with this statement, the Purposes and Procedures Manual of the NAIC Securities Valuation Office, and the designation assigned in the NAIC Valuations of Securities product prepared by the NAIC Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve

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6 Changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater) generally should not result in the recognition of an other-than-temporary impairment. For plain-vanilla, variable-rate beneficial interests, the yield is changed to reflect the revised interest rate based on the contractual interest rate reset formula. For example, if a beneficial interest pays interest quarterly at a rate equal to LIBOR plus 2 percent, the yield of that beneficial interest is changed prospectively to reflect changes in LIBOR. However, changes in the fair value of a plain-vanilla, variable-rate beneficial interest due to credit events should be considered when evaluating whether there has been an other-than-temporary impairment.
(AVR), 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 fair value. For reporting entities that do not maintain an AVR, loan-backed securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

26. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

27. The application of this reporting requirement resulting from NAIC designation (i.e., lower of cost or fair value) is not a substitute for other-than-temporary impairment recognition (paragraphs 32-36). For securities reported at fair value where an other-than-temporary impairment has been determined to have occurred, the realized loss recognized from the other-than-temporary impairment shall first be applied towards the realization of any unrealized losses previously recorded as a result of fluctuations in the security’s fair value due to the reporting requirements. After the recognition of the other-than-temporary impairment, the security shall continue to report unrealized gains and losses as a result of fluctuations in fair value.

28. If the fair value of a loan-backed or structured security is less than its amortized cost basis at the balance sheet date, an entity shall assess whether the impairment is other than temporary. Amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized as a realized loss (including any cumulative-effect adjustments recognized in accordance with paragraphs 55 through 57 of this Statement).

29. If an entity intends to sell the loan-backed or structured security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred.

30. If an entity does not intend to sell the loan-backed or structured security, the entity shall assess whether it has the intent and ability\(^7\) to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.

31. If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security and the entity has the intent and ability to hold. Therefore, in those situations, an other-than-temporary impairment shall be considered to have occurred. In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (that is, a non-interest related decline\(^8\) exists), and an other-than-temporary impairment shall be considered to have occurred. A decrease in cashflows expected to be collected on a loaned-backed or structured security that results from an increase in prepayments

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\(^7\) This assessment shall be considered a high standard due to the accounting measurement method established for the securities within the scope of this Statement (amortized cost).

\(^8\) A non-interest related decline is a decline in value due to fundamental credit problems of the issuer. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due. An interest related decline in value may be due to both increases in the risk-free interest rate and general credit spread widening.
on the underlying assets shall be considered in the estimate of the present value of cashflows expected to be collected.

32. In determining whether a non-interest related decline exists, an entity shall calculate the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired loan-backed or structured security, discounted at the security’s effective interest rate.

   a. For securities accounted for under paragraphs 12 through 16 – the effective interest rate of the loan-backed or structured security is the rate of return implicit in the security (that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the security).9

   b. For securities accounted for under paragraphs 17 through 19 – the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment.

   c. For securities accounted for under paragraphs 20 through 24 – the reporting entity shall apply the guidance in paragraph 22.b.

33. When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized.)

34. When an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment’s amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security’s effective interest rate in accordance with paragraph 32. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized for the non-interest related decline. Hence, unrealized losses could continue to be reflected for these securities due to the reporting requirements.)

35. For reporting entities required to maintain an AVR or IMR, the accounting for the other-than-temporary impairment shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. Non-interest related other-than-temporary impairment losses shall be recorded through the AVR. If the reporting entity wrote the security down to fair value due to the intent to sell or does not have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the non-interest related portion of the other-than-temporary impairment losses shall be recorded through the AVR; the interest related other-than-temporary impairment losses shall be recorded through the IMR.

36. For situations where an other-than-temporary impairment is recognized pursuant to paragraphs 33 and 34 of this Statement, the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. Therefore, the prospective adjustment method shall be used for periods subsequent to loss recognition.

9 See Footnote 1.
37. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income. A reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security.

   a. For securities accounted for under paragraphs 12 through 19, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with paragraphs 17 through 19. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new amortized 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.

   b. For beneficial interests accounted for under paragraphs 20 through 24, a reporting entity shall apply the guidance in paragraphs 21 through 22 to account for changes in cash flows expected to be collected.

38. It is inappropriate to automatically conclude that a security is not other-than-temporarily impaired because all of the scheduled payments to date have been received. However, it also is inappropriate to automatically conclude that every decline in fair value represents an other-than-temporary impairment. Further analysis and judgment are required to assess whether a decline in fair value indicates that it is probable that the holder will not collect all of the contractual or estimated cash flows from the security. In addition, the length of time and extent to which the fair value has been less than cost can indicate a decline is other than temporary. The longer and/or the more severe the decline in fair value, the more persuasive the evidence that is needed to overcome the premise that it is probable that the holder will not collect all of the contractual or estimated cash flows from the issuer of the security.

39. In making its other-than-temporary impairment assessment, the holder shall consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of future cash flows. Such information generally shall include the remaining payment terms of the security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral. To achieve that objective, the holder shall consider, for example, industry analyst reports and forecasts, sector credit ratings, and other market data that are relevant to the collectibility of the security. The holder also shall consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract) and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by “nontraditional loans”). Thus, the holder shall consider whether a security backed by currently performing loans will continue to perform when required payments increase in the future (including “balloon” payments). The holder also shall consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral

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10 A nontraditional loan may have features such as (a) terms that permit principal payment deferral or payments smaller than interest accruals (negative amortization), (b) a high loan-to-value ratio, (c) multiple loans on the same collateral that when combined result in a high loan-to-value ratio, (d) option adjustable-rate mortgages (option ARMs) or similar products that may expose the borrower to future increases in repayments in excess of increases that result solely from increases in the market interest rate (for example, once negative amortization results in the loan reaching a maximum principal accrual limit), (e) an initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends, and (f) interest-only loans that should be considered in developing an estimate of future cash flows.
has declined, the holder needs to assess the effect of that decline on the ability of the holder to collect the balloon payment.

**Origination Fees**

40. 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 8 of this statement. Other origination fees shall be recorded as income upon receipt.

**Origination, Acquisition, and Commitment Costs**

41. 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 7 of this statement. 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**

42. 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.

43. 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 8 of this statement 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.

**Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities**

44. 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.

45. 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.

46. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. 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.

47. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

Disclosures

48. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed securities shall be made in the financial statements. Regardless of the allowances within paragraph 59 of the Preamble, the disclosures in paragraph 48f, 48g and 48h are required in separate, distinct notes to the financial statements:

a. Fair values in accordance with SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27);

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the loan-backed securities are stated;

d. The adjustment methodology used for each type of security (prospective or retrospective);

e. Descriptions of sources used to determine prepayment assumptions.

f. All securities within the scope of this statement with a recognized other-than-temporary impairment, disclosed in the aggregate, classified on the basis for the other-than-temporary impairment: (1) intent to sell, (2) inability or lack of intent to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, or (3) present value of cash flows expected to be collected is less than the amortized cost basis of the security.

g. For each security with a recognized other-than-temporary impairment, currently held by the reporting entity, as the present value of cash flows expected to be collected is less than the amortized cost basis of the securities:

i. The amortized cost basis, prior to any current-period other-than-temporary impairment.

ii. The other-than-temporary impairment recognized in earnings as a realized loss.

iii. The fair value of the security.

iv. The amortized cost basis after the current-period other-than-temporary impairment.

h. All impaired securities (fair value is less than cost or amortized cost) for which an other-than-temporary impairment has not been recognized in earnings as a realized
loss (including securities with a recognized other-than-temporary impairment for non-interest related declines when a non-recognized interest related impairment remains):

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27.

j. Additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value in accordance with SSAP No. 27, the investor should disclose the following additional information, if applicable:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

49. Refer to the preamble for further discussion regarding disclosure requirements. All disclosures within this Statement shall be included within the interim and annual statutory financial statements.

Relevant Literature

50. This statement adopts FASB Emerging Issues Task Force No. 99-20, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security and FASB Staff Position EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20. This statement adopts paragraphs 5, 7 and 9 of AICPA Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer (SOP 03-03) for loan-backed and structured securities only. With the exception of this specific adoption, consideration of SOP 03-03 is still pending consideration for statutory accounting.

51. This statement rejects FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities and FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.


Effective Date and Transition

53. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.
54. For securities purchased prior to January 1, 1994, where historical cash flows are not readily available for applying the retrospective method, the reporting entity 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.

55. This revised statement supersedes SSAP No. 98 and paragraph 13 of SSAP No. 99 effective September 30, 2009. For reporting entities that either early adopted the requirements of SSAP No. 98 or previously adopted a statutory accounting policy that was in accord with the prescriptions of SSAP No. 98, for which an other-than-temporary impairment was previously recognized, and if such reporting entities do not intend to sell the security, and have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, those reporting entities shall recognize the cumulative effect of reversing the impact of the adoption of SSAP No. 98, or an equivalent statutory accounting policy, and paragraph 13 of SSAP No. 99 as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements.

56. The accounting and reporting requirements of this revised statement shall be applied to existing and new investments held by a reporting entity on or after September 30, 2009. For loan-backed and structured securities held at the beginning of the interim period of adoption (July 1, 2009) and continue to be held as of September 30, 2009, for which an other-than-temporary impairment was previously recognized under SSAP No. 43, if a reporting entity does not intend to sell the security, and has the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the reporting entity shall recognize the cumulative effect of initially applying this revised statement as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements. The cumulative effect on unassigned funds (surplus) shall be calculated by comparing the present value of the cash flows expected to be collected determined in accordance with the methodology in paragraph 32, as applicable, with the amortized cost basis of the loan-backed and structured security as of the beginning of the interim period in which this revised statement is adopted (July 1, 2009). The cumulative-effect adjustment shall include related tax effects. The discount rate used to calculate the present value of the cash flows expected to be collected shall be the rate in effect before recognizing any other-than-temporary impairments and not a rate that has been adjusted to reflect those impairments.

57. The amortized cost basis of a security for which an other-than-temporary impairment was previously recognized shall be adjusted by the amount of the cumulative-effect adjustment before taxes. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income (see paragraph 37).

58. In the period of adoption, an entity shall provide the disclosures required by SSAP No. 3 for changes in accounting principles.

AUTHORITATIVE LITERATURE

Statutory Accounting

• Purposes and Procedures Manual of the NAIC Securities Valuation Office

• NAIC Valuations of Securities manual prepared by the Securities Valuation Office

RELEVANT ISSUE PAPERS

• Issue Paper No. 43—Loan-Backed and Structured Securities

• Issue Paper No. 140—Substantive Revisions to SSAP No. 43—Loan-Backed and Structured Securities, Revised September, 2009
6. This Issue Paper is intended to provide a historical reference of SSAP No. 43, SSAP No. 98 and SSAP No. 99 prior to the adoption of SSAP No. 43R. SSAP No. 43R was adopted in September 2009 with an effective date of September 30, 2009.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. Statutory accounting principles for loan-backed and structured securities was included within SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 43). This guidance has been superseded by SSAP No. 43R:

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities. In accordance with SSAP No. 91R, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.

SUMMARY CONCLUSION

2. Loan-backed securities are 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.

3. Structured securities are 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.

4. Loan-backed securities 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.

5. Loan-backed securities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

6. At acquisition, loan-backed securities shall be reported at cost, including brokerage and related fees. Cost shall not exceed fair value. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.
Amortization

7. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded 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 repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

Balance Sheet Amount

8. Loan-backed securities shall be valued and reported in accordance with this statement, the Purposes and Procedures Manual of the NAIC Securities Valuation Office, and the designation assigned in the NAIC Valuations of Securities product prepared by the NAIC Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), 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 fair value. For reporting entities that do not maintain an AVR, loan-backed securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

9. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

Changes in Valuation

10. Prepayments are a significant variable element in the cash flow of loan-backed securities 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 reporting entity to reinvest assets 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. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, that should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.

11. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically. For securities that have the potential for loss of a portion of the original investment, the review shall be performed at least quarterly. For other securities, the review shall be performed at least annually. In addition to assets that are delinquent or otherwise not generating cash flows, other 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 these securities, an effective yield or internal rate of return is calculated at acquisition based on the purchase price and anticipated future cash flows.

12. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall 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 each prepayment assumption shall be documented by the reporting entity.

13. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities.

14. 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 the prospective 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.

15. 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**

16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined an other than temporary impairment has occurred, the cost basis of the 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. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. 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.

17. NOTE: This paragraph is added by SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment. Remaining paragraphs are renumbered.

In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. 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 impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

**Income**

18. Interest shall be accrued using the interest method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income 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.

19. For reporting entities required to maintain an IMR, the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date and shall be reported as net realized capital gains or losses in the Statement of Income.

20. 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. These fees shall be reported as investment income when received.

Beneficial Interests

21. A holder of a beneficial interest in securitized financial assets should recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date over the initial investment as interest income over the life of the beneficial interest using the effective yield method.

22. The holder of a beneficial interest should continue to update the estimate of cash flows over the life of the beneficial interest. Based on current information and events, if a favorable or adverse change in estimated cash flows is projected, the holder should recalculate the amount of interest income for the beneficial interest on the date of evaluation. The recalculated yield should be used to recognize interest income as a prospective change over the remaining life of the beneficial interest. Impairment for beneficial interests shall be determined in accordance with paragraph 16.

Origination Fees

23. 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 7 of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

24. 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 6 of this statement. 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

25. 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.

26. 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 7 of this statement 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.

Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities

27. 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.

28. 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.

29. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. 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.

30. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

Disclosures

31. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed securities shall be made in the financial statements:

   a. Fair values in accordance with SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27);

   b. Concentrations of credit risk in accordance with SSAP No. 27;

   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, for applying the retrospective method, the reporting entity has elected 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; and

g. Descriptions of sources used to determine prepayment assumptions.

h. For each balance sheet presented, all securities in an unrealized loss position for which other-than-temporary declines in value have not been recognized

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

j. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27.

k. As of the date of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

l. The aggregate related fair value of securities with unrealized losses.

m. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27.

j. As of the date of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value in accordance with SSAP No. 27, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

a. The aggregate carrying value of the investments not evaluated for impairment, and

b. The circumstances that may have a significant adverse effect on the fair value.

32. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraphs 31a., 31b., 31h., 31i., 31j., and 31k. above shall be included in the annual audited statutory financial reports only.

Relevant Literature

33. This statement rejects FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities and FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.


Effective Date and Transition

35. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.
36. For securities purchased prior to January 1, 1994, where historical cash flows are not readily available for applying the retrospective method, the reporting entity 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.

8. SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 98) amended paragraphs 14 through 16 of SSAP No. 43. This guidance was superseded with the issuance of SSAP No. 43R:

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for impairment analysis and subsequent valuation of loan-backed and structured securities.

SUMMARY CONCLUSION

2. This statement amends paragraphs 14 through 16 of SSAP No. 43—Loan-Backed and Structured Securities to the following:

14. 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 the prospective 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 security is determined to be other than temporarily impaired.

15. 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

16. If it is determined that the decline in fair value of the security is other than temporary, then the cost basis of the security shall be written down to fair value. The amount of the write down shall be accounted for as a realized loss. An interest related decline in value shall be considered other than temporary only when a reporting entity has the intent to sell the investment, at the reporting date, before recovery of the cost of the investment. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. Credit related other than temporary impairment losses shall be recorded through the AVR; interest related other than temporary impairment losses shall be recorded through the 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.

Disclosures

3. This statement requires no additional disclosures.
Effective Date and Transition

4. This statement is effective for quarterly and annual reporting periods beginning on or after January 1, 2009, with early adoption permitted and encouraged. A change resulting from the adoption of this statement shall be accounted for prospectively. No cumulative effect adjustments or application of the new guidance to prior events or periods are required, similar to a change in accounting estimate.

9. SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment (SSAP No. 99) establishes statutory accounting principles for the treatment of premium or discount applicable to certain securities subsequent to the recognition of an other-than-temporary impairment. Paragraph 13 of SSAP No. 99 inserted a new paragraph into SSAP No. 43. Consistent with the superseding of SSAP No. 43 by SSAP No. 43R, paragraph 13 of SSAP No. 99 (and the new paragraph inserted within SSAP No. 43) have also been superseded:

Loan-Backed and Structured Securities

13. This statement shall insert the following new paragraph 17 into SSAP No. 43, with subsequent paragraphs of SSAP No. 43 to be renumbered accordingly:

17. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. 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 impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Disclosures

14. This statement requires no additional disclosures.

Generally Accepted Accounting Principles

10. The adoption of SSAP No. 43R did not adopt or reject any GAAP standards.

RELEVANT LITERATURE

Statutory Accounting

- SSAP No. 43—Loan-Backed and Structured Securities
- SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities
- SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment
- Issue Paper No. 43—Loan-Backed and Structured Securities
- Issue Paper No. 124—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments: An Amendment to SSAP No. 43—Loan-Backed and Structured Securities
- Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment
Generally Accepted Accounting Principles

- None

State Regulations

- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 143

Prospective-Based Guaranty Fund Assessments

STATUS:
Finalized October 18, 2010

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on guaranty funds and assessments is provided within SSAP No. 35—Guaranty Fund and Other Assessments (SSAP No. 35). SSAP No. 35 rejected the GAAP guidance for recording guaranty fund and other assessments previously contained within AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments (SOP 97-3) and currently included within the Accounting Standards Codification 405-30, Insurance Related Assessments (ASC 405-30).

2. As detailed within Issue Paper No. 35, Accounting for Guaranty Fund and Other Assessments (Issue Paper No. 35), SOP 97-3 defined the condition of obligation differently than Issue Paper No. 35. Issue Paper No. 35 identified that 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. Issue Paper No. 35 also identified that SOP 97-3 was rejected because it was inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts, as well as the accounting principles set out in Issue Paper No. 5, Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). Issue Paper No. 35 identified that language from SOP 97-3 regarding the ‘Ability to Reasonably Estimate the Liability’ was incorporated into statutory accounting.

3. The purpose of this Issue Paper is to re-evaluate the previous conclusion within Issue Paper No. 35, and reflected within SSAP No. 35, regarding the adoption of SOP 97-3 (ASC 405-30) for statutory accounting.

SUMMARY CONCLUSION

4. 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.

5. Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to a formal determination of insolvency. Pre-funded guaranty fund assessments and premium-based administrative-type assessments 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 losses on which the assessments are expected to be based are incurred.

6. For premium-based assessments, the event that obligates the entity is generally writing the premiums 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.

7. For loss-based assessments, the event that obligates the entity is an entity incurring the losses on which the assessments are expected to be based.

8. The following provides guidance on how guaranty-fund assessments and other insurance-related assessments should be applied:

a. Retrospective-premium-based guaranty-fund assessments – An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. Prospective-premium-based guaranty-fund assessments – The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based. Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency.

i. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

ii. In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments should recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. Prefunded-premium-based guaranty fund assessments – A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related premiums are written.

d. Other premium-based assessments – Other premium-based assessments shall be accounted for in the same manner as prefunded-premium-based guaranty-fund assessments.
e. **Loss-based assessments** – An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related loss is incurred.

**DISCUSSION**

9. Current statutory accounting guidance within SSAP No. 35 rejected the provisions of SOP 97-3, and required assessments for guaranty fund obligations to be accrued at the time of the insolvency, regardless of whether an event that “obligates” the reporting entity (i.e., the writing of premiums) has occurred. This position was considered necessary to be consistent with the concepts of conservatism and recognition outlined in the Statement of Concepts.

10. Before codification (and SSAP No. 35), the statutory accounting practice was driven by the line of insurance written by the reporting entity. For life insurers, assessments were accrued at the time of the insolvency, as the guaranty fund obligations were based on premiums written prior to the insolvency. For property and casualty insurers, the practice varied to reflect when the premiums were written. For assessments based on premiums written after an insolvency, the assessment was accrued when the premiums were written, as this was considered the event that obligated the entity.

11. Interested parties have identified that after the adoption of SSAP No. 35, property and casualty insurers have been able to develop estimates of their respective market shares, but that these insurers have had difficulty in trying to estimate the ultimate loss expected from insolvencies. Although property and casualty insurers have worked with the National Conference of Insurance Guaranty Funds (NCIGF) and various State Guaranty Fund Associations in an attempt to obtain additional information related to the ultimate loss expected from insolvencies, the rate information provided by the NCIGF does not extend beyond one year. Additionally, the NCIGF information does not provide sufficient data to allow for the calculation of an ultimate expected assessment exposure, which is necessary to meet the SSAP No. 35 requirements.

12. Interested parties also identified that the range of outcomes among property and casualty insurers illustrates that there is a lack of consistency of estimates among these reporting entities. This lack of consistency creates concern as to the extent SSAP No. 35 can be applied reliably. Based on the request of interested parties, the Statutory Accounting Principles Working Group formed the Guaranty Fund Subgroup to review the current statutory requirements within SSAP No. 35 and reconsider the adoption of SOP 97-3 (ASC 405-30).

13. To complete an assessment, the Subgroup conducted state surveys and received information from the NCIGF. In considering the results of state surveys, several states noted that waiting to record prospective-based guaranty fund assessments until the obligating premium was written would not impact their assessment of the insurers. A few states indicated that waiting would actually improve their assessment of the insurer as the liability information would be more accurate. In contrast, two states specifically noted that insurers should not wait to record the liability on their financial statements, and thus favored the current SSAP No. 35 approach.

14. After considering the presentation by NCIGF, the Subgroup concluded that in addition to mirroring the GAAP requirements, adopting the approach within ACS 405-30 (SOP 97-3) would result with the recognition of liabilities that are better estimates, more consistently determined, and more verifiable than the existing statutory approach.

   a. **Better Estimates** - Using the current approach, it has been communicated that insurers do not have adequate information to calculate ultimate expected assessment exposure as of the liquidation date. It has been communicated that relying on the last annual statement

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filed of the insolvent insurer would not be timely or provide the best estimate for assessments. This is due to limited filed financial statement information, if any, if rehabilitation or runoff has occurred prior to insolvency. Insurers have communicated that they can use the NCIGF “Assessment Liability Report” to estimate their assessment liabilities and that this report is accepted by auditors as support for determining assessment liabilities under ACS 405-30 (SOP 97-3).

b. More Consistently Determined – The guaranty associations determine annually how much to assess the insurance industry according to their funding needs. State laws establish the maximum assessment percentage that can be assessed by a guaranty association per year. Under the prospective assessment method, used by 54 of the 57 guaranty associations (as reported by the NCIGF), the assessment amount is a percentage of direct written premiums for the prior year for lines covered by the guaranty association. Assessments received by the guaranty association in a particular year are used to fund claims originating from all insolvencies, regardless of when those insolvencies occurred. Prospective-premium based assessments are assessments made on premiums written after an insolvency occurs; assessments in any year are generally limited to a percentage of premiums written the year before the assessment is made.

c. More Verifiable – It has been communicated that utilizing the GAAP method improves the auditability of property and casualty insurer estimates as the information is based on “real” data. As previously stated in this issue paper, it has been communicated that the information provided by the NCIGF, which is in accordance with the GAAP standards, is accepted as support for the insurance company’s assessment liability.

15. The Subgroup also noted that the inconsistencies in reporting and the lack of verifiable information reduced the conservative benefits received under the existing guidance in SSAP No. 35. As the result of these findings, the Subgroup agreed to present an Issue Paper to the Working Group proposing substantive revisions to SSAP No. 35 to incorporate the ASC 405-30 (SOP 97-3) approach for guaranty fund liability recognition. Under this approach, accounting requirements for guaranty fund assessments would be determined in accordance with the type of guaranty-fund assessment imposed, and incorporate the concept of an ‘obligating event’ for prospective-based premium assessments in determining whether liability accrual should occur.

16. Exhibit A includes the proposed substantive revisions to reflect the adoption with modification of ASC 405-30 (SOP 97-3), in the form of SSAP No. 35R—Guaranty Form and Other Assessments – Revised (SSAP No. 35R). The substantive revisions are proposed to be initially effective for the reporting period beginning January 1, 2011.

17. Statutory accounting modifications from ASC 405-30 (SOP 97-3) are as follows:

a. The option to discount accrued liabilities (and reflect the time value of money of anticipated recoverables) is rejected for statutory accounting. Liabilities for guaranty funds or other assessments shall not be discounted.

b. The use of a valuation allowance for premium tax offsets and policy surcharges no longer probable for realization has been rejected for statutory accounting. Evaluation of assets shall be made in accordance with SSAP No. 5, and if it is probable that the asset is no longer realizable, the asset shall be written off and charged to income in the period the determination is made.

c. Guidance within ASC 405-30 pertaining to noninsurance entities has been rejected as not applicable for statutory accounting.
18. SSAP No. 35 has three statutory accounting interpretations (INTs). No revisions are considered necessary to these interpretations as a result of the substantive revisions proposed within SSAP No. 35R:

a. INT 02-22: Accounting for the U.S. Terrorism Risk Insurance Program (INT 02-22) – This interpretation indicates that there is a transfer of underwriting insurance risk under the Terrorism Insurance Program and accordingly, the recovery of such losses should be reported as reinsured losses. This interpretation also indicates that because the terrorism loss risk-spreading premium is imposed on policyholders as a surcharge, and that the Department of Treasury provides for insurers to collect the surcharge and “remit amounts collected to the Secretary”, the surcharge generally meets the requirements of paragraph 10 of SSAP No. 35:

10. In certain circumstances, a reporting entity acts as an agent for certain state or federal 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 shall 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 or federal agency is contingent upon collection from the insured.

b. INT 03-01: Application of SSAP No. 35 to the Florida Hurricane Catastrophe Fund (INT 03-01) – This interpretation was nullified due to Florida Legislative Changes.

c. INT 07-03: EITF 06-3: How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation) (INT 07-03) – This interpretation discusses the correct accounting treatment of taxes charged to a customer by collected and remitted by a reporting entity. Similar to INT 02-22, this interpretation focuses on the application of paragraph 10 and how the collection of assessments or charges from policyholders shall impact the reporting entity’s financial statements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

19. SSAP No. 35 provides the following guidance:

1. This statement establishes statutory accounting principles for guaranty fund and other assessments.

2. Guaranty fund assessments represent a funding mechanism employed by states 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 reporting entities in the state. Guaranty funds generally make assessments after an insolvency based upon retrospective premium writings.

3. This statement addresses other assessments including but not limited to workers’ compensation second injury funds and for funds that pay operating costs of an insurance department, a state guaranty fund, and/or the workers’ compensation board. This statement also
addresses health related assessments including but not limited to state health insurance high-risk pools, health insurance small group and individual reinsurance pools, state health demographic or risk adjustment assessments.

SUMMARY CONCLUSION

4. This statement applies SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5) to guaranty fund and other assessments. SSAP 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 the 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 the above 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 redistributed 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 or other 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 4 a. 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 4 b. requires that the amounts can be reasonably estimated. For guaranty fund 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 SSAP 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 management’s estimate in the range shall be accrued. For purposes of this statement, 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 SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement. 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 or federal 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 shall 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 or federal agency is contingent upon collection from the insured.

Disclosures

11. Describe the nature of any assessments that could have a material financial effect and state the estimate of the liability or that an estimate cannot be made. To the extent assessments have been accrued disclose the amounts of the liabilities, any related asset for premium tax credits or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

12. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

13. This statement rejects GAAP guidance for recording guaranty fund and other assessments, which is contained in AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments.

Generally Accepted Accounting Principles

14. Accounting Standards Codification 405-30, Insurance-Related Assessments (ASC 405-30) provides the following guidance:

405-30-05 Overview and Background

05-1 Insurance entities as well as noninsurance entities are subject to a variety of assessments related to insurance activities, including those by state guaranty funds and workers’ compensation second-injury funds. Some entities may be subject to insurance-related
assessments because they self-insure against loss or liability. This Subtopic provides guidance on accounting for insurance-related assessments.

**State Guaranty Funds**

05-2 States have enacted legislation establishing guaranty funds. The state guaranty funds assess entities licensed to sell insurance in the state to provide for the payment of covered claims or to meet other insurance obligations—subject to prescribed limits—of insolvent insurance entities. The assessments are generally based on premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. At least one state, however, assesses entities before insolvencies.

05-3 State guaranty funds use a variety of methods for assessing entities. This Subtopic identifies the following four primary methods of guaranty-fund assessments:

- **Retrospective-premium-based assessments.** Guaranty funds covering benefit payments of insolvent life, annuity, and health insurance entities typically assess entities based on premiums written or received in one or more years before the year of insolvency. Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

- **Prospective-premium-based assessments.** Guaranty funds covering claims of insolvent property and casualty insurance entities typically assess entities based on premiums written in one or more years after the insolvency. Assessments in any year are generally limited to an established percentage of an entity’s premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

- **Prefunded-premium-based assessments.** At least one state uses this kind of assessment to cover claims of insolvent property and casualty insurance entities. This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed before any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.

- **Administrative-type assessments.** These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency.

05-4 State laws often allow for recoveries of guaranty-fund assessments by entities subject to assessments through such mechanisms as premium tax offsets, policy surcharges, and future premium rate structures. The policy surcharges referred to in this Subtopic are those surcharges that are intended to provide an opportunity for assessed entities to recover some or all of the amounts assessed over a period of time.

**Other Insurance-Related Assessments**

05-5 Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established other funds supported by assessments. The two most prevalent uses for such assessments are as follows:

- **To fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers’ compensation board).**

- **To fund second-injury funds, which provide reimbursement to insurance carriers or employers for workers’ compensation claims when the cost of a second injury**
combined with a prior accident or disability is greater than what the second accident alone would have produced. The employer of an injured or handicapped worker is responsible only for the workers' compensation benefit for the most recent injury; the second-injury fund would cover the cost of any additional benefits for aggravation of a prior condition or injury. The intent of the fund is to help insure that employers are not made to suffer a greater monetary loss or increased insurance costs because of hiring previously injured or handicapped employees.

05-6 The primary methods used to assess for these other insurance-related assessments are the following:

a. Premium-based. The assessing entity imposes the assessment based on the entity's written premiums. The assessing entity may be at the state, county, municipality, or other such level. The base year of premiums is generally either the current year or the year preceding the assessment.

b. Loss-based. The assessing entity imposes the assessment based on the entity's incurred losses or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

405-30-10 Objectives

10-1 The objective of this Subtopic is to establish consistent accounting and disclosures for guaranty-fund and other insurance-related assessments to improve comparability of reported information.

405-30-15 Scope and Scope Exceptions

Entities

15-1 The guidance in this Subtopic applies to all entities that are subject to guaranty-fund and other insurance-related assessments, including entities that are subject to insurance-related assessments because they self-insure against loss or liability. For example, one state specifies that self-insurers of workers’ compensation should use as a base for assessment the amount of premium the self-insurer would have paid if it had insured its liability with an insurer for the previous calendar year.

Transactions

15-2 The guidance in this Subtopic applies to assessments mandated by statute or regulatory authority that are related directly or indirectly to underwriting activities (including self-insurance), except for income taxes and premium taxes.

15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

a. Amounts payable or paid as a result of reinsurance contracts or arrangements that are in substance reinsurance, including assumed reinsurance activities and certain involuntary pools that are covered by Topic 944.

b. Assessments of depository institutions related to bank insurance and similar funds.
405-30-25 Recognition

Reporting Liabilities
25-1 Entities subject to assessments shall recognize liabilities for insurance-related assessments when all of the following conditions are met:

a. **Probability of assessment.** An assessment has been imposed or information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates it is probable that an assessment will be imposed.

b. **Obligating event.** 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. **Ability to reasonably estimate.** The amount of the assessment can be reasonably estimated.

See Examples 1 through 3 (paragraphs 405-30-55-1 through 55-15) for illustrations of the computation of assessment liabilities.

Probability of Assessment
25-2 Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable before a formal determination of insolvency. For purposes of this Subtopic, a formal determination of insolvency occurs when an entity meets a state's (ordinarily the state of domicile of the insolvent insurer) statutory definition of an insolvent insurer. In most states, the 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.

25-3 Prefunded guaranty-fund assessments and premium-based administrative-type assessments, as defined in paragraph 405-30-05-3, 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 losses on which the assessments are expected to be based are incurred.

Obligating Event
25-4 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 an entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment identified in this Subtopic:

a. For premium-based assessments, the event that obligates the entity is generally writing the premiums 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 entity cannot avoid paying a particular assessment even if that insurance entity 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. For example, in certain states, an insurance entity may remain liable for assessments even though the insurance entity discontinues the writing of premiums. In this circumstance, the underlying cause of the liability is not the writing of the premium, but the insolvency. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.
b. 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.

**Ability to Reasonably Estimate**

25-5 One of the conditions (see paragraph 450-20-25-2(b)) for recognition of a liability is that the amount can be reasonably estimated. Paragraph 450-20-25-5 provides that some amount of loss can be reasonably estimated when available information indicates that the estimated amount of the loss is within a range of amounts. Paragraph 450-20-30-1 explains that, if no amount within the range is a better estimate than any other amount, the minimum amount in the range should be accrued.

**Applying the Recognition Criteria**

25-6 Application of the recognition criteria in paragraphs 405-30-25-1 through 25-5 to the methods used to address guaranty-fund assessments and other insurance-related assessments, as described in paragraphs 405-30-05-3 through 05-6, is as follows:

a. *Retrospective-premium-based guaranty-fund assessments.* An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. *Prospective-premium-based guaranty-fund assessments.* The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based (for example, multiple-year contracts under which an insurance entity has no discretion to avoid writing future premiums). Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency. Law or regulatory practice affects the event that obligates the entity in either of the following ways:

1. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

2. In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments shall recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. *Prefunded-premium-based guaranty-fund assessments.* A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related premiums are written.

d. *Other premium-based assessments.* Other premium-based assessments, as described in paragraph 405-30-05-5, would be accounted for in the same manner as prefunded-premium-based guaranty-fund assessments.
e. **Loss-based assessments.** An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related loss is incurred.

25-7 Administrative-type assessments are generally expensed in the period assessed.

**Asset for Premium Tax Offsets and Policy Surcharges**

25-8 When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset shall be recognized for that recovery.

25-9 For retrospective-premium-based assessments, to the extent that it is probable that paid or accrued assessments will result in a recoverable amount in a future period from business currently in force considering appropriate persistency rates for long-duration contracts (see paragraph 405-30-30-11), an asset shall be recognized at the time the liability is recorded.

25-10 An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

25-11 Policy surcharges that are required as a pass-through to the state or other regulatory bodies shall be accounted for in a manner such that amounts collected or receivable are not recorded as revenues and amounts due or paid are not expensed (meaning, similar to accounting for sales tax).

405-30-30 Initial Measurement

**Estimating the Liability**

30-1 Entities subject to assessments may be able to obtain information to assist in estimating the total guaranty-fund cost or the following years' assessments, as appropriate, for an insolvency from entities such as the state guaranty fund associations, the National Organization of Life and Health Insurance Guaranty Associations, and the National Conference of Insurance Guaranty Funds.

30-2 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 will incur costs and pay claims that will determine the amounts and the timing of assessments.

30-3 The best available information about market share or premiums by state and premiums by line of business shall be used to estimate the amount of an insurance entity's future assessments.

30-4 If a noninsurance entity's assessments are based on premiums, it may be necessary to consider the amount of premium the self-insurer would have paid if it had insured its liability with an insurer. If a noninsurance entity's assessments are based on losses, it shall consider the losses that have been incurred by the entity when determining the liability. Most often, assessments that have an impact on noninsurance entities that self-insure workers' compensation obligations are for second-injury funds. Second-injury funds generally assess insurance entities and self-insurers based on paid losses.

30-5 A noninsurance entity may develop an accrual for its second-injury liability based on any of the following:
a. The ratio of the entity's prior period paid workers' compensation claims to aggregate workers' compensation claims in the state that was used as a basis for previous assessments

b. Total fund assessments in prior periods

c. Known changes in the current period to either the number of employees self-insured by the entity or the number of workers who are the subject of recoveries from the second-injury fund that might alter total fund assessments and the entity's proportion of the total fund assessments.

30-6 Estimates of loss-based assessments shall be consistent with estimates of the underlying incurred losses and shall be developed based on enacted laws or regulations and expected assessment rates.

30-7 Estimates of some insurance-related assessment liabilities may be difficult to derive. The development or determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment. Examples of uncertainties include the following:

a. Limitations, as provided by statute, on the amount of individual contract liabilities that the guaranty fund will assume, that cause the guaranty fund associations' liability to be less than the amount by which the entity is insolvent

b. Contract provisions (for example, credited rates) that may be modified at the time of the insolvency or alternative payout options that may be offered to contract holders that affect the level and payout of the guaranty fund's liability

c. The extent and timing of available reinsurance recoveries, which may be subject to significant uncertainties

d. Alternative strategies for the liquidation of assets of the insolvent entity that affect the timing and level of assessments

e. Certain liabilities of the insolvent insurer that may be particularly difficult to estimate (for example, asbestos or environmental liabilities).

30-8 Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be reevaluated regularly during the assessment process. For some ranges, there may be amounts that appear to be better estimates than any other within the range. If this is the case, the liability recorded shall be based on the best estimate within the range. For ranges in which there is no such best estimate, the liability that should be recorded shall be based on the amount representing the minimum amount in the range.

Present Value Measurement of the Obligation

30-9 Current practice in the insurance industry is to allow, but not require (with limited exceptions, such as pensions and postretirement benefits), the discounting of liabilities to reflect the time value of money when the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability.

30-10 Similarly, for assessments that meet those criteria, the liability may be recorded at its present value by discounting the estimated future cash flows at an appropriate interest rate.

Asset for Premium Tax Offsets and Policy Surcharges

30-11 The asset recognized under paragraph 405-30-25-8 shall be measured based on current laws and projections of future premium collections or policy surcharges from in-force policies. In
determining the asset to be recorded, in-force policies do not include expected renewals of short-duration contracts but do include assumptions as to persistency rates for long-duration contracts.

30-12 The time value of money need not be considered in the determination of the recorded amount of a potential recovery if the liability is not discounted. In instances in which the recovery period for an asset is substantially longer than the payout period for the liability, it may be appropriate to record the asset on a discounted basis regardless of whether the liability is discounted.

30-13 The recognition of such assets related to prospective-premium-based assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. The expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments shall be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

405-30-35 Subsequent Measurement

Asset for Premium Tax Offsets and Policy Surcharges

35-1 The asset recorded under paragraph 405-30-25-8 for premium tax offsets and policy surcharges shall be subject to a valuation allowance to reflect any portion of the asset that is no longer probable of realization. Considering expected future premiums other than on in-force policies in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate.

405-30-50 Disclosure

50-1 Sections 275-10-50 and 450-20-55 address disclosures related to loss contingencies. That guidance is applicable to assessments covered by this Subtopic. Additionally, if amounts have been discounted, the entity shall disclose in the financial statements the undiscounted amounts of the liability and any related asset for premium tax offsets or policy surcharges as well as the discount rate used. If amounts have not been discounted, the entity shall disclose in the financial statements the amounts of the liability, any related asset for premium tax offsets or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

405-30-55 Implementation Guidance and Illustrations

Illustrations

Example 1: Prospective-Premium-Based Assessment

55-1 This Example illustrates application of the recognition and measurement guidance in this Subtopic to a prospective-premium-based assessment. This kind of assessment is considered prospective because the assessment relates to premium written after the insolvency. As a result of insolvencies in prior years, ABC Property & Liability Insurance Company (ABC) expects to be assessed in the future by the guaranty fund in a state where it writes premiums. Any such assessments will be limited to 2 percent of premium writings in the prior year and are recoverable through premium tax offsets on a ratable basis over the 5-year period following the year of each assessment.

55-2 Although it does not expect to do so, ABC is free to cease writing the lines of business that are subject to the guaranty-fund assessments.

55-3 As of December 31, 19X0, ABC has neither paid nor received a notice of an assessment related to the insolvencies. Based on communications from the state guaranty association, ABC expects to receive an assessment in 19X1, which is allocated among entities based on 19X0 market share, for at least 1 percent of 19X0 premiums that are subject to the assessment. A best estimate cannot be determined, and no amount within the range of estimates (meaning, from 1 to
2 percent of 19X0 premiums) is a better estimate than any other amount, therefore the minimum amount in the range shall be accrued.

55-4 As of December 31, 19X0, ABC should recognize a liability equal to 1 percent of the premiums written in 19X0 that are subject to the assessment. No additional liability should be recognized, and no asset related to the premium tax offset should be recognized. Disclosure of the loss contingency of up to an additional 1 percent of the subject premiums should be considered.

55-5 ABC would recognize a liability only for those future assessments it is obligated to pay as a result of the premiums written. Because ABC is not obligated to write any future premiums, its liability is limited to that related to premiums written in 19X0. Because no amount within the range of estimates is a better estimate than any other amount, the minimum amount in the range is accrued. Further, because the premium tax offset is realizable only on business that will be written in the future (that is, 19X2 and subsequent years), no asset or receivable is recognized as of December 31, 19X0.

Example 2: Retrospective-Premium-Based Assessment

55-6 This Example illustrates application of the recognition and measurement guidance in this Subtopic to a retrospective-premium-based assessment. As a result of an insolvency that occurred during 19X0, DEF Life and Health Insurance Company (DEF) expects to be assessed in the future by the guaranty fund in a state where it has written business. Any such assessment will be based on DEF's average market share, determined based on premiums that are subject to the assessment for the three years before the insolvency, and limited to 2 percent of the average annual subject premiums for the three years before the insolvency. Further, such assessments are recoverable through premium tax offsets over the five-year period following the year of payment for each assessment.

55-7 As of December 31, 19X0, DEF has not paid or received a notice of an assessment related to the insolvency. Based on initial input from the National Organization of Life and Health Insurance Guaranty Associations and experience with other insolvencies, DEF assumes that the first assessment will not be made until 19X3 and that it will take three to five annual assessments for the guaranty fund to be able to meet its obligations. Based on the estimated nationwide cost of the insolvency and the distribution of the insolvent entity's business, DEF estimates that its assessment will be at least 1 percent of the average annual premiums that are subject to the assessment. No amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for 3 to 5 years) is a better estimate than any other amount, therefore the minimum amount in the range shall be accrued.

55-8 As of December 31, 19X0, DEF should recognize a liability for 3 years of assessments at 1 percent of the average annual premiums that are subject to the assessment (that is, the assessments expected in 19X3, 19X4, and 19X5). Disclosure of the loss contingency for additional assessments (meaning, in 19X6 and 19X7) or assessment of greater than 1 percent of the average annual premiums that are subject to the assessment should be considered. An asset related to premium tax offsets that are available on accrued assessments would be recorded provided there were sufficient premium taxes based on business in force at December 31, 19X0 (with assumed levels of policy retention), to allow realization of the asset.

55-9 The resulting recognized liability and asset are as follows (shown on both a discounted and undiscounted basis, based on paragraphs 405-30-30-9 through 30-12, discounting is optional), assuming average annual subject premiums of $100,000 for the 3 years before the insolvency.
55-10 DEF would record a liability for all future assessments related to the insolvency. Because no amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for 3 to 5 years) is a better estimate than any other amount, the minimum amount in the range (meaning, 1 percent per year for 3 years of assessments) is accrued.

55-11 Since it is assumed that based on the anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset, the premium tax offset is recorded.

**Example 3: Loss-Based Assessment**

55-12 This Example illustrates application of the recognition and measurement guidance in this Subtopic to a loss-based assessment. GHI Industrial Company (GHI) is self-insured for workers' compensation and therefore participates in the second injury fund in the state where it conducts operations. GHI is entitled to recover from the fund some or all of the indemnity claims for previously injured workers. GHI is also subject to annual assessments (maximum of 1 percent per year) on indemnity claims paid each year.

55-13 Assessment rates have been climbing steadily, from 0.6 percent 5 years previous to 0.75 percent in 19X0.

55-14 As of December 31, 19X0, GHI should have an assessment liability recognized for 0.75 percent of its liability for the payment of future indemnity claims, unless there was information to support the assessment rate being reduced or the assessments being eliminated in the future. Disclosure of the loss contingency of up to an additional 0.25 percent of the liability for the payment of future indemnity claims should be considered.

55-15 GHI would recognize a liability based on the current assessment rate, unless there was clear evidence that the rate would change. The liability would be based on the entire liability base that was subject to the assessment.

**RELEVANT LITERATURE**

Statutory Accounting

- SSAP No. 5—Liabilities, Contingencies and Impairments of Assets
- SSAP No. 35—Guaranty Fund and Other Assessments
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 35—Accounting for Guaranty Fund and Other Assessments
Generally Accepted Accounting Principles

- Accounting Standards Codification 405-30, Insurance-Related Assessments
- SOP 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments

State Regulations

- No additional guidance obtained from state statutes or regulations.
Guaranty Fund and Other Assessments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for guaranty fund and other assessments.

2. Guaranty fund assessments represent a funding mechanism employed by states 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 reporting entities in the state. Guaranty funds generally make assessments after an insolvency based upon retrospective premium writings.

3. This statement addresses other assessments including but not limited to workers’ compensation second injury funds and for funds that pay operating costs of an insurance department, a state guaranty fund, and/or the workers’ compensation board. This statement also addresses health related assessments including but not limited to state health insurance high-risk pools, health insurance small group and individual reinsurance pools, state health demographic or risk adjustment assessments.

SUMMARY CONCLUSION

4. This statement adopts with modification guidance from Accounting Standard Codification 405-30, Insurance-Related Assessments (ASC 405-30) as reflected within this SSAP. Consistent with ASC 405-30-25-1, entities subject to assessments shall recognize liabilities for insurance-related assessments when all of the following conditions are met (paragraph 13 provides guidance on applying the recognition criteria): applies SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5) to guaranty fund and other assessments. SSAP No. 5 requires accrual of a liability when both of the following conditions are met:

a. An assessment has been imposed or information available prior to issuance of the statutory financial statements indicates that it is probable that an assessment will be imposed, 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 event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements.

b-c. The amount of the assessment can be reasonably estimated.

For the 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 the above 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 redistributed back to the participating entities based upon the cost of specific claims, enrollment demographics, or other criteria affecting health care expenses. This standard does not permit liabilities for guaranty funds or other assessments to be discounted.
5. For refunded guaranty or other 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 premium-based guaranty fund assessments, except those that are prefunded, 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. Prefunded guaranty-fund assessments and premium-based administrative type assessment 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 losses on which the assessments are expected to be based are incurred.

7. Subparagraph 4b requires that the event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements. Based on 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 an entity. The following defines the event that obligates an entity to pay an assessment:

a. For premium-based assessments, the event that obligates the entity is generally writing the premiums 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 entity cannot avoid paying a particular assessment even if that insurance entity 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. For example, in certain states, an insurance entity may remain liable for assessments even though the insurance entity discontinues the writing of premiums. In this circumstance, the underlying cause of the liability is not the writing of the premium, but the insolvency. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

b. 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.

7-8. Subparagraph 4 b.c. requires that the amounts can be reasonably estimated. For retrospective-premium-based guaranty fund 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. Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be re-evaluated regularly during the assessment process. Changes in the amount of the liability (or asset) as information becomes available over time 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.
In accordance with SSAP 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 management’s estimate in the range shall be accrued. For purposes of this statement, 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.

**Reporting Assets for Premium Tax Offsets and Policy Surcharges**

10. The liability for accrued assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset shall be recognized for that recovery in an amount that is determined based on current laws, projections of future premium collections or policy surcharges from in-force policies, and as permitted in accordance with subparagraphs 10a, 10b and 10c. Any recognized asset from premium tax credits or policy surcharges shall be re-evaluated regularly to ensure recoverability. Upon expiration, tax credits no longer meet the definition of an asset and shall be written off.

a. **For Because assessments are generally paid before premium tax credits are realized or policy surcharges are collected, an asset may—results, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These amounts represent receivables, to the extent it is probable they will be realized, meet the definition of assets, as specified in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement. The asset shall be established and reported independent from the liability (not reported net).**

b. **Assets recognized from accrued liability assessments shall be determined in accordance with the type of guaranty fund assessment as detailed in the following subparagraphs. Assets recognized from accrued liability assessments meet the definition of an asset under SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement.**

i. For retrospective-premium-based and loss-based assessments, to the extent that it is probable that accrued liability assessments will result in a recoverable amount in a future period from business currently in-force considering appropriate persistency rates for long-duration contracts, an asset shall be recognized at the time the liability is recorded. (In-force policies do not include expected renewals of short-term contracts.

ii. For prospective-premium-based assessments, the recognition of assets from accrued liability assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SSAP requires reporting entities to recognize prospective-based-premium assessments as the premium is written or obligated to be written by the reporting entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments shall be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

c. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.
11. An evaluation of assets recognized under paragraph 10 shall be made in accordance with SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5) to determine if there is any impairment. If, in accordance with SSAP No. 5, it is probable that the asset is no longer realizable, the asset shall be written off to the extent it is not realizable and charged to income in the period the determination is made. Considering expected future premiums other than on in-force policies in evaluating recoverability of premium tax offsets or policy surcharges is not permitted.

**Acting as an Agent for Collection and Remittance of Fees and Assessments**

40.12 In certain circumstances, a reporting entity acts as an agent for certain state or federal 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 shall 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 or federal agency is contingent upon collection from the insured.

**Applying the Recognition Criteria**

13. Application of the recognition criteria in paragraph 4:

a. **Retrospective-premium-based guaranty-fund assessments** - An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. **Prospective-premium-based guaranty-fund assessments** - The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based (for example, multiple-year contracts under which an insurance entity has no discretion to avoid writing future premiums). Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency. Law or regulatory practice affects the event that obligates the entity in either of the following ways:

i. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

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1 As detailed within paragraph 6 for premium-based guaranty-fund assessments, an 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.
ii. In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments shall recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. **Prefunded-premium-based guaranty-fund assessments** - A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related premiums are written.

d. **Other premium-based assessments** - Other premium-based assessments shall be accounted for in the same manner as prefunded premium-based guaranty-fund assessments.

e. **Loss-based assessments** - An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related loss is incurred.

f. **Administrative-type assessments** – As this assessment is typically an annual amount per entity assessed to fund operations of the guaranty association, regardless of the existence of an insolvency, such assessments are generally expensed in the period assessed.

**Disclosures**

11.14. A reporting entity shall disclose the following:

a. Describe the nature of any assessments that could have a material financial effect, by type of assessment, and state the estimate of the liability, identifying whether the corresponding liability has been recognized under paragraph 4, a liability has not been recognized as the obligating event has not yet occurred, or that an estimate cannot be made.

b. For the extent assessments with liabilities recognized under paragraph 4, have been accrued, disclose the amounts of the recognized liabilities, any related asset for premium tax credits or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

c. Disclose assets recognized from paid and accrued premium tax offsets or policy surcharges, and include a reconciliation of assets recognized within the previous year’s Annual Statement to the assets recognized in the current year’s Annual Statement. The reconciliation shall reflect, in aggregate, each component of the increase and decrease in paid and accrued premium tax offsets and policy surcharges, including the amount charged off.

d. Disclosures shall be made in accordance with paragraph 14 of SSAP No. 5 when there is at least a reasonable possibility that the impairment of an asset from premium tax offsets or policy surcharges may have been incurred.

12.15. Refer to the preamble for further discussion regarding disclosure requirements.
Relevant Literature

16. This statement rejects adopts GAAP guidance for recording guaranty fund and other assessments, which is contained in Accounting Standards Codification 405-30. Insurance Related Assessments (ASC 405-30) to the extent reflected in this SSAP. AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments. Statutory accounting modifications from ASC 405-30 are as follows:

   a. The option to discount accrued liabilities (and reflect the time value of money in anticipated recoverables) is rejected for statutory accounting. Liabilities for guaranty funds or other assessments shall not be discounted.

   b. The use of a valuation allowance for premium tax offsets and policy surcharges no longer probable for realization has been rejected for statutory accounting. Evaluation of assets shall be made in accordance with SSAP No. 5, and if it is probable that the asset is no longer realizable, the asset shall be written off and charged to income in the period the determination is made.

   c. Guidance within ASC 405-30 pertaining to noninsurance entities has been rejected as not applicable for statutory accounting.

Effective Date and Transition

17. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. Substantive revisions to paragraphs 4, 6, 7, 8, 10, 11, 13 and 14 are initially effective for the reporting period beginning January 1, 2011. The result of applying this revised Statement shall be considered a change in accounting principle in accordance with SSAP No. 3. Pursuant to SSAP No. 3, the cumulative effect of changes in accounting principles shall be reported as an adjustment to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect recognized through surplus from initial application of this Statement shall reflect the removal of liabilities established under SSAP No. 35, and the re-establishment of liabilities required under SSAP No. 35R. If there is no change in the liabilities recognized (for example, retrospective-premium based assessments), no cumulative effect adjustment shall occur. With regards to assets, the entity shall complete an assessment of the SSAP No. 35 asset reported as of the transition date. If it is determined that the reported asset exceeds what is allowed under SSAP No. 35R, then the excess asset shall be written-off, through unassigned funds, so the ultimate asset reflected corresponds with what is permitted under SSAP No. 35R. Although it is possible that the excess asset will be reinstated once the liability assessment is recognized (prospective-premium based assessments), it is inappropriate to continue to reflect an asset for assessments that are not reflected within the financial statements.

RELEVANT ISSUE PAPERS

- Issue Paper No. 35—Accounting for Guaranty Fund and Other Assessments
- Issue Paper No. 143—Prospective-Based Guaranty Fund Assessments
Exhibit A – Primary Methods of Guaranty Fund Assessments:

a. **Retrospective-premium-based assessments** - Guaranty funds covering benefit payments of insolvent life, annuity, and health insurance entities typically assess entities based on premiums written or received in one or more years before the year of insolvency. Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

b. **Prospective-premium-based assessments** - Guaranty funds covering claims of insolvent property and casualty insurance entities typically assess entities based on premiums written in one or more years after the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

c. **Prefunded-premium-based assessments** - This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed before any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.

d. **Administrative-type assessments** - These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency.

d. **Other premium-based assessments** - Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (a) to fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (b) to fund second-injury funds.

i. **Premium-based** - The assessing organization imposes the assessment based on the entity's written premiums. The base year of premiums is generally either the current year or the year preceding the assessment.

ii. **Loss-based** - The assessing organization imposes the assessment based on the entity's incurred losses or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.
Statutory Issue Paper No. 144

Substantive Revisions to SSAP No. 91R—Securities Lending

STATUS:
Finalized November 29, 2010

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to document for the historical record the substantive changes to statutory accounting guidance adopted in May 2010 within SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—Revised (SSAP No. 91R).

2. This Issue Paper illustrates tracked changes adopted in SSAP No. 91R, with an effective date of December 31, 2010. The substantive revisions adopted within SSAP No. 91R include revised accounting guidance for securities lending, repurchase agreements, reverse repurchase agreements and disclosures.

3. For historical record, the adopted guidance reflected as tracked changes has been included as appendix A.

DISCUSSION

4. This Issue Paper is intended to provide as a historical reference tracked changes adopted within SSAP No. 91R. The substantive changes were proposed by the Securities Lending Subgroup of the Statutory Accounting Principles Working Group, which was composed of interested parties and regulators. The primary goal of the group was to clarify securities lending accounting, including rules on collateral.

5. The Working Group determined that changes were necessary, as the existing guidance for collateral for securities lending was inconsistently applied.

6. In addition, the repurchase and reverse repurchase agreement definitions were essentially reversed to be more consistent with the investment industry use of the terms.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. Prior statutory accounting guidance in SSAP No. 91R regarding securities lending is superseded by the updates to SSAP No. 91R adopted in May 2010.

Generally Accepted Accounting Principles

8. The substantive revisions adopted in SSAP No. 91R did not adopt or reject any new GAAP standards but it did incorporate guidance regarding the determination of whether collateral is on balance sheet or off balance sheet which is closer to the existing GAAP guidance. There are still modifications from GAAP in that the SSAP No. 91R guidance indicates that “if the reporting entity or its agent can sell or repledge the collateral
AUTHORITATIVE LITERATURE

Statutory Accounting

· Statement of Statutory Accounting Principles No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

· Statement of Statutory Accounting Principles No. 33—Securitization

· Statement of Statutory Accounting Principles No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements

· NAIC Purposes and Procedures Manual of the NAIC Securities Valuation Office

· Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91

Generally Accepted Accounting Principles

· FASB Statement No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140

· FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

· FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions

· AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position

· FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement

· FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold

· FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues

· FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios

· FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement

· FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights

· FASB Emerging Issues Task Force No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments
RELEVANT ISSUE PAPERS

- Issue Paper No. 122—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91

State Regulations

- No additional guidance obtained from state statutes or regulations.
ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This statement discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement. Securitizations of nonfinancial assets are outside the scope of this statement.

SUMMARY CONCLUSION

2. See SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25) for additional accounting and disclosure guidance concerning related party transactions. In addition the guidance for the following topics have been addressed in Interpretations of the Emerging Accounting Issues Working Group (INT):

   a. Transfers of ownership interest that are in substance sales of real estate - INT 99-22 resolved this conflict between application of SSAP No. 40—Real Estate (SSAP No. 40) and SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18).

   b. Exchanges of equity method investments for similar productive assets - INT 99-21 resolved this conflict between application of SSAP No. 28—Nonmonetary Transactions (SSAP No. 28) and SSAP No. 18.

3. SSAP No. 18, SSAP No. 33—Securitization (SSAP No. 33) and SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (SSAP No. 45) are superseded by the conclusions outlined in this statement.

4. This statement does not address the securitization of mortality or morbidity risk. The National Association of Insurance Commissioners’ (NAIC’s) Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the development of model laws, model regulations and proposed accounting guidance for the securitization of mortality and morbidity risk. When such proposed accounting guidance is finalized, the development of a statement will be considered.

5. Except as discussed in paragraphs 56 and 9497, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 17 and 18);

   b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraphs 19-23), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 25 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that
right (see paragraph 24), to pledge or exchange those interests and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provide more than a trivial benefit to the transferor; and

c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 38-40) or (ii) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 22-23 and 41-45).

6. Upon completion of any transfer of financial assets, the transferor shall:

a. Initially recognize and measure at fair value, if practicable, servicing assets and servicing liabilities assumed under a separate contractual obligation to service financial assets (see paragraphs 51 and 50);

b. Allocate the previous carrying amount between the assets sold, if any, and the interests that continue to be held by a transferor, if any, based on their relative fair values at the date of transfer (see paragraphs 48 and 49); and

c. Continue to carry in its balance sheet any interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and undivided interests continued to be held by the transferor (see paragraphs 7c., 48 and 49).

7. Upon completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 5), the transferor (seller) shall:

a. Eliminate the transferred assets from the balance sheet;

b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests continued to be held by the reporting entity, if any, and the securities representing beneficial interests not continued to be held, if any, based on the relative fair values of the transferred assets at the date of transfer;

c. Record in its balance sheet, the allocated carrying value of the securities representing beneficial interests continued to be held in the assets (e.g., loan-backed securities). Subsequent to the transfer of assets:

i. Retained residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

ii. Beneficial interests continued to be held shall be accounted for in accordance with the statutory accounting principles for the specific asset type (e.g., bonds shall be accounted for in accordance with SSAP No. 26—Bonds, excluding Loan–backed and Structured Securities, loan-backed securities shall be accounted for in accordance with SSAP No. 43R—Loan-backed and Structured Securities (SSAP No. 43R), preferred stock in accordance with SSAP No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities) (SSAP No. 32).

d. Recognize all additional assets obtained (i.e., other than the securities representing beneficial interests continued to be held which are recorded in accordance with 7 c.) and liabilities incurred in consideration as proceeds of the sale;
e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see SSAP No. 100—Fair Value Measurements), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 50); and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

8. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value.

9. Repurchase agreements, reverse repurchase agreements, collateral requirements, and dollar repurchase agreements are described in paragraphs 64-66 and 67-69. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales as discussed in paragraphs 64-66 and disclosed as required by paragraph 97. 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.

10. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 5, or (b) is a sale of receivables with recourse (see paragraph 97); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 13).

Recognition and Measurement of Servicing Assets and Liabilities

11. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. Servicing rights become a distinct asset or liability of the reporting entity pursuant to:

a. A transfer of the servicer’s financial assets that meets the requirements for sale accounting;

b. A transfer of financial assets to a qualifying SPE in a guaranteed mortgage obligation in which the transferor retains all of the resulting securities; or

c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer.

A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying assets remaining on the transferor’s balance sheet shall not be recognized as a servicing asset or servicing liability.

12. If distinct servicing rights exist in accordance with the above guidelines, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. Servicing assets and servicing liabilities shall be measured initially at fair value. Servicing assets or liabilities shall be measured subsequently at fair value at each reporting date with fluctuations in fair value reported
as unrealized gains and losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses.

Secured Borrowings and Collateral

13. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 10). The accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party or its agent has taken control over the collateral, and on the rights to sell or repledge and obligations that result from the collateral arrangement, and on whether the debtor has defaulted.

a. If the secured party (transferee) or its agent has the right by contract to sell or repledge the collateral, and then the debtor (transferor) shall report that asset in its balance sheet, does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:

i. The debtor shall reclassify that asset and report that asset in its balance sheet separately (for example, as security pledged to creditors) from other assets not so encumbered;

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 (transferee) sells or repledges collateral pledged to it, on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized it. The sale or repledging of the collateral asset is a transfer subject to the provisions of this statement.

c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the collateral pledged asset, it shall derecognize the collateral pledged asset, and the secured party (transferee) shall recognize the collateral asset (to the extent it has not already recognized it) and initially measure it at fair value; or, if it has already sold the collateral, derecognize its obligation to return the collateral.

d. Except as provided in paragraph 13.(c), the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

14. Insurers Reporting entities may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. If the assets pledged are recorded as admitted assets under SSAP No. 4—

\[^{1}\text{Cash "collateral," sometimes used, for example, in securities lending transactions, shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing.}\]
Assets and Nonadmitted Assets (SSAP No. 4) and are not impaired under the provisions of SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5), the pledging insurer records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 13 above shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an admitted asset for the amount of collateral that it can redeem.

Extinguishments of Liabilities

15. A debtor shall derecognize a liability if, and only if, it has been extinguished (see SSAP No. 15—Debt and Holding Company Obligations (SSAP No. 15)). A liability has been extinguished if either of the following conditions is met:

   a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds; or

   b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

16. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

Isolation Beyond the Reach of the Transferor and Its Creditors

17. 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—depends on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor. Transactions between related parties or affiliates are accounted for in accordance with SSAP No. 25.

18. 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

19. Sale accounting is allowed under paragraph 5 only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right also matter. Many transferor-imposed or other conditions on a transferee’s right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer’s business or someone that the loan customer might consider an undesirable creditor. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

20. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

21. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor’s Rights or Obligations to Reacquire Transferred Assets

22. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 5. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are
readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 5.

23. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets, as discussed in paragraphs 41-45, thus precluding sale accounting under paragraph 5.

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

24. The considerations in paragraphs 19-23, about conditions that may or may not constrain a transferee that is not a qualifying SPE from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a beneficial interest holder (BIH) from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

25. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:

a. It is demonstrably distinct from the transferor (paragraphs 26 and 27);

b. Its permitted activities:
   i. Are significantly limited;
   ii. Were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; and
   iii. May be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 28 and 29).

c. It shall hold only:
   i. Financial assets transferred to it that are passive in nature (paragraph 30);
   ii. Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 30 and 31);
   iii. Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE;
   iv. Servicing rights related to financial assets that it holds;
   v. Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 32);
vi. Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:

i. Occurrence of an event or circumstance that:

(a) Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

(b) Is outside the control of the transferor, its affiliates, or its agents; and

(c) Causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 33 and 34.)

ii. Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder’s beneficial interest back to the SPE (paragraph 35);

iii. Exercise by the transferor of a call specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 41-45);

iv. Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 36).

Need to Be Demonstrably Distinct from the Transferor

26. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either:

a. At least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents; or

b. The transfer is a guaranteed mortgage securitization.

27. An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

28. The powers of the SPE must be limited to those activities allowed by paragraph 25 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.
29. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 5b. are then met by the SPE itself and the conditions in paragraphs 5a. and 5c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 46).

Limits on What a Qualifying SPE May Hold

30. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing. An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control, as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88 (SSAP No. 97) over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments that would allow it and its related entities to control 10% of more of the financial instruments issuer; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE’s assets.

31. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

   a. Is entered into:
      i. When the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents; or
      ii. When a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold.

   b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently;

   c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

32. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets.

Limits on Sales or Other Dispositions of Assets

33. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that:
a. Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

b. Is outside the control of the transferor, its affiliates, or its agents; and

c. Causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them include requirements to dispose of transferred assets in response to:

i. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee;

ii. A default by the obligor;

iii. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating;

iv. The involuntary insolvency of the transferor; or

v. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

34. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure;

b. A requirement to dispose of marketable equity securities upon a specified decline from their “highest fair value” if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE;

c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

35. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets;

b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put);

c. New beneficial interests in those assets.

36. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of
prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Investments in Special-Purpose Entities

37. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88 (SSAP No. 97). Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25.

Agreements That Maintain Effective Control Over Transferred Assets

38. 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 39);
   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 40);
   c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and
   d. The agreement is entered into concurrently with the transfer.

39. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

   a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);
   b. Identical form and type so as to provide the same risks and rights;
   c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);
   d. Identical contractual interest rates;
   e. Similar assets as collateral; and
   f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

40. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.
Ability to Unilaterally Cause the Return of Specific Transferred Assets

41. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 5. For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor’s maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor’s maintaining effective control, because it is the issuer rather than the transferor who holds the call.

42. If the transferee is a qualifying SPE, it has met the conditions in paragraph 25 and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor’s effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor’s unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

43. A call that is attached to transferred assets maintains the transferor’s effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor’s effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor’s effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

44. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets; because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

45. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guarantee (paragraph 33c.i.) or only after a BIH other than the transferor, its affiliate, or its agent
requires a qualifying SPE to repurchase that beneficial interest (paragraph 35b.), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor's Regaining Control of Assets Sold

46. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor’s regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 5 are no longer met. Such a change, unless it arises solely from either the initial application of this statement or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 7). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 29). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor. Subsequent to that date, the reporting entity shall follow statutory accounting for the assets and liabilities in accordance with the guidance in the SSAPs.

Assets Obtained and Liabilities Incurred as Proceeds

47. The proceeds from a sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. 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 of the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Interests That Continue to be Held by a Transferor

48. Other interests in transferred assets, those that are not part of the proceeds of the transfer, are interests that continue to be held by the transferor over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the interests that continue to be held by a transferor, based on their relative fair values. That procedure shall be applied to all transfers in which interests continue to be held by the transferor, even those that do not qualify as sales. Examples of interests that continue to be held by a transferor include securities backed by the transferred assets, undivided interests, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is an interest continued to be held or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 47.

49. If the interests that continue to be held by a transferor are subordinated to more senior interests held by others, that subordination may concentrate into the interests that continue to be held by a transferor most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the interests that continue to be held by a transferor. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated interest continued to be held is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the interest continued to be held being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated interest continued to be held.
If It Is Not Practicable to Estimate Fair Values

50. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

   a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

   b. The amount that would be recognized in accordance with SSAP No. 5.

Securitizations

51. Financial assets such as mortgage loans are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties also have been securitized. Securitizations of nonfinancial assets are outside the scope of this statement.

52. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

53. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

54. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 5 qualify for sale accounting under this statement. All financial assets obtained or continued to be held and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 7; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Sales of Future Revenues

55. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.


56. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). If there is a ROAP, the transfer of assets shall not be accounted for as a sale.
Securities Lending Transactions

57. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor’s balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor’s balance sheet and a separate liability shall be established on the transferor’s balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:

a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities;

b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.

58. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer’s failure to deliver securities sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

59. 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 38-40). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder or its agent 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 or securities borrowed, and any rebate paid to the transferee of securities is interest on the cash or securities the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured
borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 13 and 57.

6059. In some transactions, characterized as securities lending, all or off the conditions in paragraph 5 are met, securities lending transactions shall be accounted for, including the effective control criterion in paragraph 5c., and consideration other than beneficial interests in the transferred assets is received. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:

a. By the transferor as a sale of the “loaned” securities, for proceeds consisting of the collateral\(^2\) and a forward repurchase commitment—(if the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and

b. By the transferee as a purchase of the “borrowed” securities in exchange for the collateral and a forward resale commitment. 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.

6460. The transferor of securities being “loaned” accounts for collateral received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The collateral received shall be recognized as the transferor’s asset—as shall investments made with that collateral, even if made by agents or in pools with other securities lenders—along with the obligation to return the collateral. If securities that may be sold or repledged are received by the transferor or its agent, the transferor of the securities being “loaned” accounts for those securities in the same way as it would account for collateral received. Collateral which may be sold or repledged by the transferor or its agent is reflected on balance sheet, along with the obligation to return the asset\(^3\). Collateral received which may not be sold or repledged by the transferor or its agent is off balance sheet\(^4\). For collateral on the balance sheet, the reporting is determined by the administration of the program.

a. Securities lending programs where the collateral received by the reporting entity’s unaffiliated agent that can be sold or repledged is reported on the balance sheet. The collateral received and reinvestment of that collateral by the reporting entity’s unaffiliated agent shall be reflected as a one-line entry on the

\(^2\) If the “collateral” in a transaction that meets the criteria in paragraph 5 is a financial asset that the holder or its agent is permitted by contract or custom to sell or repledge, 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 or its agent is not permitted by contract or custom to sell or repledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

\(^3\) If cash is received by the transferor or its agent and reinvested or repledged it is reported on balance sheet. It is explicitly intended that when the lender bears reinvestment risk, that collateral is on balance sheet.

\(^4\) An example of collateral which is off balance sheet is securities are received by the transferor or its agent in which the collateral must be held and returned, without the ability to transfer or repledge the collateral. This would involve limited situations in which the transferor or agent is prohibited from reinvesting the collateral.
balance sheet (Securities Lending Collateral) and a detailed schedule will be required each quarter and at year-end to list the description of the collateral asset. This description shall include the NAIC rating, fair value, book adjusted carrying value and maturity date. A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities).

b. Securities lending programs where the collateral received by the reporting entity that can be sold or repledged is reported on the balance sheet. If the reporting entity is the administrator of the program, then, the collateral received and any reinvestment of that collateral is reported with the invested assets of the reporting entity based on the type of investment (i.e. bond, common stock, etc). A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities).

c. Securities lending programs where the collateral received by the reporting entity’s affiliated agent can report using either one line reporting (paragraph 60 a.) or investment schedule reporting (paragraph 60 b.).

6261. Reinvestment of the collateral by the reporting entity or its agent, shall follow the same impairment guidance as other similar invested assets reported on the balance sheet. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous investment income.

Securities Lending Transactions – Collateral Requirements

6362. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral by the end of the next business day, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

6463. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral by the end of the next business day, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

Repurchase Agreements and "Wash Sales"

64-64. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party"), transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements are.

\[ \text{Instead of cash, other securities or letters of credit sometimes are exchanged.} \]
meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

62.65. Repurchase agreements can be affected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee or its agent 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.

63.66. If the criteria in paragraph 5 are met, including the criterion in paragraph 5c., the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets. (Repurchase financing is addressed in paragraphs 70-75.)

64.67. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales under this 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.

65.68. 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 5 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 39) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

66.66. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

**Repurchase Agreements**

67.70. Repurchase agreements are defined as agreements under which a reporting entity purchases—sells securities and simultaneously agrees to repurchase—recall the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 39 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.

68.71. For repurchase agreements that are accounted for as collateralized borrowings in accordance with paragraph 65.68 of this statement, the underlying securities shall not continue to be accounted for as an 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. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

7269. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Repurchase Financing

739. Repurchase financing is a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer.

741. A repurchase financing involves the transfer of a previously transferred financial asset back to the initial transferee as collateral for a financing between the initial transferee (the borrower) and the initial transferor (the lender). A repurchase financing also typically involves the initial transferor returning the transferred financial asset (or substantially the same asset) to the initial transferee when the financing is repaid on a stated date. A repurchase financing is entered into in contemplation of the initial transfer if both transactions are considered together at the execution of the initial transfer.

752. When the transferor transfers a financial asset and also enters into a repurchase financing with the transferee, there are typically three transfers of the financial assets:

a. Initial transfer – An initial transferor transfers a financial asset to an initial transferee.

b. Repurchase financing – The initial transferee (the borrower) transfers the previously transferred financial asset back to the initial transferor (the lender) as collateral for a financing between the initial transferor and initial transferee.

c. Settlement – The initial transferor (the lender) returns the financial asset (or substantially the same asset) to the initial transferee (the borrower) upon receipt of payment from the initial transferee.

763. Repurchase financing that is entered into contemporaneously with, or in contemplation of, an initial transfer of a financial asset between the same counterparties (or affiliates of either counterparty) shall not be separately accounted for as a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. Unless the provisions in paragraphs 7477 are met, the initial transfer and repurchase financing shall be evaluated as a linked transaction. The linked transaction shall be evaluated to determine whether it meets the requirements for sale accounting per paragraph 5, including paragraph 5.c. If the linked transaction does not meet the requirements for sale accounting, the linked transaction shall be accounted for based on the economies of the combined transactions, which generally represent a forward contract. SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions shall be used to evaluate whether the linked transaction should be accounted for as a derivative.

774. An initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another shall be considered linked unless all of the following criteria are met at the inception of the transaction:
a. The initial transfer and the repurchase financing are not contractually contingent on one another. Even if no contractual relationship exists, the pricing and performance of either the initial transfer or the repurchase financing must not be dependent on the terms and execution of the other transaction.

b. The repurchase financing provides the initial transferor with recourse to the initial transferee upon default. That recourse must expose the initial transferor to the credit risk of the initial transferee, or its affiliates, and not solely to the market risk of the transferred financial asset. The initial transferee’s agreement to repurchase the previously transferred financial asset (or substantially the same asset) for a fixed price and not fair value.

c. The financial asset subject to the initial transfer and repurchase financing is readily obtainable in the marketplace. In addition, the initial transfer of a financial asset and the repurchase financing are executed at market rates. This criterion may not be circumvented by embedding off-market terms in a separate transaction contemplated with the initial transfer or the repurchase financing.

d. The financial asset and repurchase agreement are not coterminous (the maturity of the repurchase financing must be before the maturity of the financial asset.)

785. In accordance with paragraph 763, an initial transfer of assets and a repurchase financing shall not be considered separate transactions unless the provisions of paragraph 7477 are met. If the provisions of paragraph 74-77 are met, the initial transfer shall be evaluated to determine whether it meets the requirements for sale accounting without taking into consideration the repurchase financing. In such situations, the repurchase financing shall then be separately analyzed as a repurchase agreement.

Reverse Repurchase Agreements

76-79. Reverse repurchase agreements are defined as agreements under which a reporting entity sells-purchases securities and simultaneously agrees to resell-repurchase the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 39 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.

7780. For reverse repurchase agreements that are accounted for as collateralized lendings borrowings in accordance with paragraph 13.68 of this statement, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently reacquired shall be reported as interest income. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

Collateral Requirements

8178. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive collateral having a fair value on the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral received from the counterparty is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be
obligated to deliver additional collateral by the end of the next business day the
fair value of which, together with the fair value of all collateral then held in
connection with the transaction, at least equals 95 percent of the fair value of the
transferred securities. If the collateral is less than 95 percent at the reporting
date, the difference between the actual collateral and 95 percent will be
nonadmitted.

Reverse Repurchase Transaction

b. The reporting entity shall receive as collateral transferred securities having a fair
value at least equal to 102 percent of the purchase price paid by the reporting
entity for the securities. If at anytime the fair value of the collateral is less than
100 percent of the purchase price paid by the reporting entity, the counterparty
shall be obligated to provide additional collateral, the fair value of which, together
with fair value of all collateral then held in connection with the transaction, at
least equals 102 percent of the purchase price.

Dollar Repurchase Agreements

8279. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase
and reverse repurchase agreements involving debt instruments that are pay-through securities
collateralized with Government National Mortgage Association (GNMA), Federal Home Loan
Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral,
and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by
the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also
commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and
dollar reverse repurchase agreements, the securities underlying the agreements must meet the
criteria defined in paragraph 39, 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.

8380. For the seller in a dollar reverse repurchase agreement accounted for as collateralized
borrowing in accordance with paragraph 65-66 of this statement, a liability is recorded for the
amount of proceeds of the sale and the sold mortgage-backed securities are not removed from
the accounting records. During the period of the agreement, interest income is recorded as if the
mortgage-backed security had been held during the term of the agreement. This is offset by an
equal amount of interest expense related to the proceeds received from the sale. Additional
interest expense is recorded representing the difference between the sales price and the
repurchase price of the mortgage-backed securities sold.

841-84. When the mortgage-backed securities are repurchased under the agreement, the original
mortgage-backed securities sold are removed from the accounting records and the purchased
mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 39.

8285. 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.

83.86. For the purchaser in a dollar repurchase agreement accounted for as collateralized lending in accordance with paragraph 65 of this statement, an asset is recorded for the amount of the purchase. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions
84.87. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 58 and 64 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting
85.88. 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.

86.89. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities; 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.

87.90. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications
88.91. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

89.92. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.
Loan Participations

90-93. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

94-95. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

96-97. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 5 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor’s right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor’s permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor’s competitor is a limitation on the transferee’s rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

93-96. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 5 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

94-97. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42—Sale of Premium Receivables.

Disclosures

95-98. A reporting entity shall disclose the following:

a. For collateral:

i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security and the fair value of the loaned security. This would also apply to separate accounts;

ii. If the entity has pledged any of its assets as collateral, the carrying amount and classification of those assets as of the date of the latest statement of financial position presented;

iii. If the entity or its agent has accepted collateral that it is permitted by contract or custom to sell or repledge it shall be recorded on the balance sheet. Regardless of whether the transaction is considered “on-
balance sheet" or "off-balance sheet", the reporting entity shall provide the following information by type of program (repurchase agreement, securities lending, or dollar repurchase agreement) as of the date of each statement of financial position: (1) the aggregate amount of contractually obligated open collateral positions (aggregate amount of securities at current fair value or cash received for which the borrower may request the return of on demand) and the aggregate amount of contractually obligated collateral positions under 30-day, 60-day, 90-day, and greater than 90-day terms, (2) the aggregate fair value of all securities acquired from the sale, trade and use of the accepted collateral (reinvested collateral), and (3) information about the sources and uses of that collateral;

iv. For securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date; and

v. For securities lending transactions administered by an affiliated agent in which "one-line" reporting (per paragraph 60a) of the reinvested collateral per paragraph 60c. is optional, at the discretion of the reporting entity, disclose the aggregate value of the reinvested collateral which is "one line" reported and the aggregate value of items which are reported in the investment schedules (per paragraph 60b). Identify the rational between the items which are one line reported and those that are investment schedule reported and if the treatment has changed from the prior period and

vi. Include separately, the amount of any loaned securities within the separate account and if the policy and procedures for the separate account differ from the general account.

b. The reporting entity shall provide the following information by type of program (repurchase agreement, securities lending or dollar repurchase agreement) with respect to the reinvestment of the cash collateral and any securities which it or its agent receives as collateral that can be sold or pledged.

i. The aggregate amount of the reinvested cash collateral (amortized cost and fair value). Reinvested cash collateral shall be broken down by the maturity date of the invested asset – under 30-day, 60-day, 90-day, 120-day, 180-day, less than 1 year, 1-2 years, 2-3 years and greater than 3 years.

ii. To the extent that the maturity dates of the liability (collateral to be returned) does not match the invested assets, the reporting entity shall explain the additional sources of liquidity to manage those mismatches.

c. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding;

d. If assets are set aside solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets;

e. 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;

f. For all servicing assets and servicing liabilities:
i. A description of the valuation techniques or other models, including significant assumptions within models, used to estimate the fair value of servicing assets and servicing liabilities; and

ii. Changes in fair value resulting from changes in valuation inputs or assumptions used in models and descriptions of other changes in fair value.

g. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the interests that continue to be held by a transferor, if any, used in determining their fair value. (Fair value shall be determined in accordance with SSAP No. 100—Fair Value Measurements.); and

ii. The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on interests that continue to be held by a transferor) and the gain or loss from sale of financial assets in securitizations;

iii. The key assumptions used in measuring the fair value of interests that continue to be held by a transferor at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and

iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests continued to be held.)

h. If the entity has interests that continue to be held by a transferor in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those interests that continue to be held by a transferor, including the methodology used in determining their fair value. (Fair value shall be determined in accordance with SSAP No. 100—Fair Value Measurements.);

ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);

iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii, above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and
iv. For the securitized assets and any other financial assets that the entity manages together with the interests that continue to be held by the transferor:

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;

(b) Delinquencies at the end of the period; and

(c) Credit losses, net of recoveries, during the period.

v. Disclosure of average balances during the period is encouraged, but not required.

i. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;

j. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

k. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

9699. Disclose any transfers of receivables with recourse.

97100. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 9, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

a. A description of the reporting entity’s objectives regarding these transactions;

b. An aggregation of transactions by NAIC designation 3 or below, or unrated;

c. The number of transactions involved during the reporting period;

d. The book value of securities sold;

e. The cost of securities repurchased; and

f. The realized gains/losses associated with the securities involved.

98-101. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 97 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

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6 Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.
Relevant Literature

100-102. The accounting guidance in this statement is consistent with the guidance included in SSAP No. 18, SSAP No. 33 and SSAP No. 45, and is expanded to include issues addressed in FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140).

100-103. This statement adopts FAS 140 with the following modifications:

a. Servicing rights assets are nonadmitted;
b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;
c. As statutory financial statements are prepared on a legal entity basis, special purpose entities shall not be consolidated in a reporting entity’s statutory financial statements;
d. Leases shall be accounted for in accordance with SSAP No. 22—Leases;
e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and
f. The concepts of revolving-period securitizations, banker’s acceptances and risk participations in banker’s acceptances are not applicable for statutory accounting purposes.
g. This statement does not adopt the accounting for collateral as outlined in FAS 140.

404-104. This statement adopts with modification FASB Statement No. 156: Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140 (FAS 156). Specific items adopted or rejected are identified below. Items within FAS 156 not specifically noted as adopted shall be considered rejected:

a. This statement adopts FAS 156 guidance indicating that all servicing assets and servicing liabilities should initially be measured at fair value.
b. This statement adopts FAS 156 guidance requiring the inclusion of separately recognized servicing assets and servicing liabilities in the calculation of proceeds from the sale of assets.
c. This statement rejects the optionality provided within FAS 156 for subsequent measurement of servicing assets and servicing liabilities using either fair value or an amortization method. This statement requires application of a fair value method for subsequent measurement.
d. This statement adopts guidance in FAS 156 confirming adoption of guidance previously adopted from FAS 140 regarding servicing assets and servicing liabilities established from the transfer of financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities.
e. This statement adopts revisions in FAS 156 replacing the term ‘retained interests’ with ‘interests that continue to be held by the transferor’ with amendments to the definition to exclude servicing assets and servicing liabilities from this definition.
This statement adopts FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP FAS 140-3) 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. This statement adopts FASB Emerging Issues Task Force (EITF) No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB EITF No. 88-18, Sales of Future Revenues, FASB EITF No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB EITF No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB EITF No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments.

This statement rejects FASB EITF No. 84-5, Sale of Marketable Securities with a Put Option, and FASB EITF No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse and FTB 01-1: Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 related to Isolation of Transferred Financial Assets.

Effective Date and Transition

This statement is effective for years beginning on and after January 1, 2005 and shall be applied prospectively. Substantive revisions in paragraphs 6, 11-12, 98f, 104 and Exhibit B illustrations are effective January 1, 2009. Substantive revisions in paragraphs 13, 59-63, 65, 71, 80, 81 and 98 regarding securities lending transactions and repurchase agreements and additional disclosures were adopted in May 2010 and are effective December 31, 2010. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

For each servicing contract in existence before January 1, 2005, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

AUTHORITATIVE LITERATURE

Statutory Accounting

- Statement of Statutory Accounting Principles No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- Statement of Statutory Accounting Principles No. 33—Securitization
- Statement of Statutory Accounting Principles No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- NAIC Purposes and Procedures Manual of the NAIC Securities Valuation Office
- Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91

Generally Accepted Accounting Principles

- FASB Statement No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140
- FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions
- AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used in Certain Audit Guides and a Statement of Position
• FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement
• FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold
• FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues
• FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios
• FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement
• FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights
• FASB Emerging Issues Task Force No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments

RELEVANT ISSUE PAPERS

• Issue Paper No. 122—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
• Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91
• Issue Paper No. 144—Substantive Revisions to SSAP No. 91R Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
EXHIBIT A - GLOSSARY

Asset Securitization

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial Interest Holder ("BIH")

Holder of beneficial interests

Cleanup Call

An option held by the servicer, which may be the transferor, to purchase transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome in relation to the benefits or servicing.

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative Financial Instrument

A derivative instrument (as defined in SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions) that is a financial instrument (refer to SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, paragraph 2).

Embedded Call (See paragraphs 41 and 43)

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.
Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Financial Liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Guaranteed Mortgage Securitization

A securitization of mortgage loans which includes a substantive guarantee by a third party.

Interests That Continue to be Held by a Transferor

Other interests in transferred assets, those that are not part of the proceeds of the transfer, over which the transferor has not relinquished control. Includes securities backed by the transferred assets, undivided interests, and cash reserve accounts and residual interests in securitization trusts.

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Residual

Residuals are a class of purchased beneficial interests or interests that continue to be held by the transferor that have rights to the last cash flows from the pool of securitized assets and are not rated by a Nationally Recognized Statistical Rating Organization (NRSRO). Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.
Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided Interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unrestricted collateral

Securities received that may be sold or pledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.

Unilateral ability (See paragraphs 41 and 42)

A capacity for action not dependent on the actions (or failure to act) of any other party.
EXHIBIT B - ILLUSTRATIONS

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

1. Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

<table>
<thead>
<tr>
<th>Fair Values</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Proceeds</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>40</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Gain on Sale</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$1,100</td>
</tr>
<tr>
<td>Carrying amount of loans sold</td>
<td>$1,000</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,050</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
</tr>
<tr>
<td>Loans</td>
<td>1,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>100</td>
</tr>
<tr>
<td>To record transfer</td>
<td></td>
</tr>
</tbody>
</table>
Illustration—Recording Transfers of Partial Interests

2. Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair values
Cash proceeds for nine-tenths sold $990
One-tenth interest continued to be held by the transferor 110

\[\frac{(990 \div 9/10) \times 1/10}{110}\]

Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Fair Value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nine-tenths interest sold $990</td>
<td>90</td>
<td>$900</td>
</tr>
<tr>
<td>One-tenth interest 110</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>Total $1,100</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Gain on Sale
Net proceeds $990
Carrying amount of loans sold 900
Gain on sale $90

Journal Entry
Cash 990
Loans 900
Gain on sale 90
To record transfer

Illustration—Sale of Receivables with Servicing Obtained

3. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans is $1,100. The fair values of the servicing asset and the interest-only strip receivable are $40 and $60, respectively.

Fair values
Cash proceeds $1,000
Servicing asset 40
Interest-only strip receivable 60

Net Proceeds
Cash proceeds $1,000
Servicing asset 40

Net Proceeds $1,040
Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Loans sold</th>
<th>Fair Value $1,040</th>
<th>Percentage of Total Fair Value 94.55</th>
<th>Allocated Carrying Amount $945.50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
<td>5.4</td>
<td>54.50</td>
</tr>
<tr>
<td>Total</td>
<td>$1,100</td>
<td>100.0</td>
<td>$1,000.00</td>
</tr>
</tbody>
</table>

**Gain on Sale**
- Net proceeds: $1,040
- Carrying amount of loans sold: $945
- Gain on sale: $94.50

**Journal Entries**
- Cash 1,000
- Interest-only strip receivable 54.50
- Servicing Asset 40
- Loans 1,000
- Gain on sale 94.50

*To record transfer and to recognize interest-only strip receivable and servicing asset*

- Interest-only strip receivable 5.50
- Equity 5.50

*To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140, paragraph 14 as revised by FAS 156)*

**Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing**

4. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans. At the date of transfer, the fair value of the loans is $1,100.
**Fair values**

- Cash proceeds $900
- Call option 70
- Recourse obligation 60
- Servicing asset 90
- One-tenth interest continued to be held by transferor 100

**Net Proceeds**

- Cash received $900
- Plus: Servicing Asset 90
- Plus: Call option 70
- Less: Recourse obligation (60)
- Net proceeds $1,000

**Carrying Amount Based on Relative Fair Values**

<table>
<thead>
<tr>
<th>Interest sold</th>
<th>Fair Value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$1,000</td>
<td>90.9</td>
<td>$909</td>
</tr>
<tr>
<td>One-tenth interest continued to be held by transferor</td>
<td>100</td>
<td>9.1</td>
<td>91</td>
</tr>
<tr>
<td>Total</td>
<td>$1,100</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Gain on Sale**

- Net proceeds $1,000
- Less: Carrying amount of loans sold (909)
- Gain on sale $91

**Loans Sold**

- Carrying Amount of Loans $1,000
- Less: Allocated carrying amount of interest that continues to be held by the transferor (91)
- Loans Sold $909

**Journal Entries**

- Cash 900
- Call option 70
- Servicing Asset 90
- Loans 909
- Recourse obligation 60
- Gain on sale 91
- To record transfer and to recognize servicing asset, call option and recourse obligation

**Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value**

5. Company E sells loans with a carrying amount of $1,000 to another entity for cash proceeds of $1,050 plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes an obligation to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate...
compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

<table>
<thead>
<tr>
<th>Fair Values</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>XX*</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>XX*</td>
</tr>
<tr>
<td>Fair value of loans transferred</td>
<td>1,100</td>
<td>1,100</td>
</tr>
</tbody>
</table>

* Not practicable to estimate fair value

<table>
<thead>
<tr>
<th>Net Proceeds</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Servicing Asset</td>
<td>XX*</td>
<td>40</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
<td>XX</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,060</td>
<td>$1,160</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Gain on Sale</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,060</td>
<td>$1,060</td>
</tr>
<tr>
<td>Carrying Amount of Loans</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>0</td>
<td>(160)</td>
</tr>
<tr>
<td>Gain on Sale</td>
<td>$ 60</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entries</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,050</td>
<td>1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0*</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Loans</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>160†</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>60</td>
<td>0</td>
</tr>
<tr>
<td>To record transfer</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.
† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

Illustration—Secured Borrowing

6. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

<table>
<thead>
<tr>
<th>Facts</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Transferor's carrying amount and fair value of security loaned</td>
<td>$1,000</td>
</tr>
<tr>
<td>Cash &quot;collateral&quot;</td>
<td>1,020</td>
</tr>
<tr>
<td>Transferor's return from investing cash collateral at a 5 percent annual rate</td>
<td>5</td>
</tr>
<tr>
<td>Transferor's rebate to the securities borrower at a 4 percent annual rate</td>
<td>4</td>
</tr>
</tbody>
</table>

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>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,020</td>
</tr>
<tr>
<td>Payable under securities loan agreements</td>
<td>1,020</td>
</tr>
</tbody>
</table>

To record the receipt of cash collateral

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities pledged to creditors</td>
<td>1,000</td>
</tr>
<tr>
<td>Securities</td>
<td>1,000</td>
</tr>
</tbody>
</table>

To reclassify loaned securities that the secured party has the right to sell or repledge

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money market instrument</td>
<td>1,020</td>
</tr>
<tr>
<td>Cash</td>
<td>1,020</td>
</tr>
</tbody>
</table>

To record investment of cash collateral

*At conclusion:*

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,025</td>
</tr>
<tr>
<td>Interest</td>
<td>5</td>
</tr>
<tr>
<td>Money market instrument</td>
<td>1,020</td>
</tr>
</tbody>
</table>

To record results of investment

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>1,000</td>
</tr>
<tr>
<td>Securities pledged to creditors</td>
<td>1,000</td>
</tr>
</tbody>
</table>

To record return of security

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable under securities loan agreements</td>
<td>1,020</td>
</tr>
<tr>
<td>Interest (&quot;rebate&quot;)</td>
<td>4</td>
</tr>
<tr>
<td>Cash</td>
<td>1,024</td>
</tr>
</tbody>
</table>

To record repayment of cash collateral plus interest

**Journal Entries for the Transferee**

*At inception:*

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable under securities loan agreements</td>
<td>1,020</td>
</tr>
<tr>
<td>Cash</td>
<td>1,020</td>
</tr>
</tbody>
</table>

To record transfer of cash collateral

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Obligation to return borrowed securities</td>
<td>1,000</td>
</tr>
</tbody>
</table>

To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

*At conclusion:*

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligation to return borrowed securities</td>
<td>1,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
</tbody>
</table>

To record the repurchase of securities borrowed

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,024</td>
</tr>
<tr>
<td>Receivable under securities loan agreements</td>
<td>1,020</td>
</tr>
<tr>
<td>Interest revenue (&quot;rebate&quot;)</td>
<td>4</td>
</tr>
</tbody>
</table>

To record the receipt of cash collateral and rebate interest
Illustration—Initial Transfer and Repurchase Financing

7. The following diagram is an example of an initial transfer of a financial asset and a subsequent repurchase financing, as described in paragraphs 70-73 and 74-74, which should be analyzed using the provisions in paragraphs 72-75-78. The purpose of this example is to illustrate the characteristics of the transaction and to prevent an inappropriate analogy to other financing transactions that are outside the scope of this SSAP.
Appendix F
Policy Statements

Introduction

The Policy Statements contained within Appendix F are not included within the Statutory Hierarchy and thus should not be considered accounting guidance. As such, the Policy Statements are included for informational purposes only.

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<table>
<thead>
<tr>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAIC Policy Statement on Maintenance of Statutory Accounting Principles</td>
<td>F-1</td>
</tr>
<tr>
<td>NAIC Policy Statement on Comments to GAAP Exposure Drafts</td>
<td>F-3</td>
</tr>
<tr>
<td>NAIC Policy Statement on Statutory Accounting Principles Maintenance Agenda Process</td>
<td>F-5</td>
</tr>
<tr>
<td>NAIC Policy Statement on Emerging Accounting Issues Agenda Process</td>
<td>F-9</td>
</tr>
</tbody>
</table>
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NAIC Policy Statement on
Maintenance of Statutory Accounting Principles

Statutory accounting principles (SAP) provide the basis for insurers to prepare financial statements to be filed with and utilized by state insurance departments for financial regulation purposes. Accuracy and completeness of such filings are critical to meaningful solvency monitoring. Accordingly, maintenance of SAP guidance for changes in the industry and changes in regulatory concerns is vital to preserving the usefulness of SAP financial statements.

The promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles (E) Working Group (SAPWG) shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The Emerging Accounting Issues (E) Working Group (EAIWG) will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Composition of the Working Groups

The chair of the Task Force shall determine membership on both working groups subject to approval by the Financial Condition (E) Committee. The groups shall be limited in size to no more that 13 members and will include representation from the four zones of the NAIC. Membership shall be vested in the state (until such time as the membership may be changed) but continuity of individuals, to the extent possible, is extremely desirable.

Development of New SSAPs

New SSAPs will be developed from time-to-time that: 1) address issues not covered by existing SAP guidance; 2) amend existing SSAPs; or, 3) supersede existing SSAPs. The decision to undertake development of a new SSAP will rest with the SAPWG subject to approval of the Task Force. The SAPWG will report to the Task Force on its agenda and progress, if any, at each national meeting of the NAIC.

As new Statements of Statutory Accounting Principles (SSAP) are developed, it is essential to review and, if necessary, update the status of Interpretations of the Emerging Accounting Issues (E) Working Group related to the SSAPs that are being replaced and/or the new SSAP being developed.

The following list of options is available to the SAPWG when an SSAP with existing interpretations is replaced:

a. **Interpretation of the new SSAP** - If the SAPWG group would like to maintain the Interpretation, the new SSAP can be added to the list of statements interpreted by the Interpretation. In addition, the status section of the new SSAP will list the Interpretation number next to the heading “Interpreted by.”

b. **Nullification** - When an Interpretation is nullified by a subsequent SSAP or superseded by another Interpretation, the Interpretation is deemed no longer technically helpful, is shaded and moved to Appendix H, Superseded SSAPs and Nullified Interpretations. The reason for the change is noted beneath the title of the Interpretation. The status section of the Interpretation describes the impact of the new guidance and the effect on the
Interpretation (for example, nullifies, incorporated in the new SSAP with paragraph reference or affects that Issue).

c. **Incorporation** - When an Interpretation is incorporated into a new SSAP the working group can choose from the following two options:

i. If the Interpretation only interprets one SSAP, then the Interpretation is listed as being nullified under the “affects” section and Interpretation is not referenced under the “interpreted by” section of the status page of the SSAP.

ii. If the Interpretation references additional SSAPs, and the working group intends to maintain the guidance, the Interpretation is unchanged (no nullification). The new SSAP (Summary of Issue section) reflects that the Interpretation issue has been incorporated into the new statement.

Research and drafting on new SSAPs will be performed by the NAIC staff under the direction and supervision of the SAPWG which may enlist the assistance of interested parties with requisite technical expertise as needed or desired. The first step in developing new SSAPs will usually be the drafting of an Issue Paper (IP), which will contain summary conclusion, discussion and relevant literature sections. Public comment will be solicited on the IPs, and at least one public hearing will be held on an IP before it is converted to a SSAP. Upon approval by the SAPWG, all proposed SSAPs will be exposed for public comment for a period commensurate with the length of the draft and the complexities of the issue. Adoption of SSAPs by the SAPWG, after hearing and any further amendments, may be by simple majority. All SSAPs must be on the agenda for at least one public hearing before presentation to the Task Force for consideration. Adoption by the Task Force, its parent and the NAIC membership shall be governed by the NAIC bylaws.

If accounting guidance, reserving standards, asset valuation standards, or any other standards or rules affecting accounting practices and procedures are developed by other NAIC working groups, task forces, subcommittees, or committees, such guidance, standards or rules must be reviewed by the SAPWG and converted to an SSAP or a revised appendix. In cases where such guidance has already been subjected to substantial due process (e.g., public comment periods or public hearings), the SAPWG may recommend to the Task Force that either the IP or SSAP comment periods may be shortened or eliminated or the hearings may be eliminated.

### Procedures for Emerging Accounting Issues (E) Working Group

The EAIWG will be responsible for responding to SAP questions that generally relate to application, interpretation and clarification. In no event shall a consensus opinion of the EAIWG amend, supersede or otherwise conflict with existing, effective SSAPs. In no event will a consensus be less than six out of quorum of nine members of the EAIWG; a consensus will also be determined by a vote of seven of 10 members, eight of 11 or 12 members, and nine of 13 members. In the rare event that an opinion of the EAIWG would create SAP not addressed by SSAPs, concurrence of SAPWG (as determined by a majority vote) will be necessary before the guidance becomes effective.

The EAIWG’s agenda will be established at the discretion of the chair, subject to approval of the Task Force. Every issue taken up by the EAIWG must be discussed at no less than two open meetings with opportunity for interested parties to present comments. The guidance contained in the consensus opinions of the group will become effective upon publication unless otherwise stated in the opinion. Consensus opinions can be overturned, amended or deferred only by a two-thirds majority of the Task Force.
NAIC Policy Statement on Comments to GAAP Exposure Drafts

As expressed in the Statement of Concepts, Statutory Accounting Principles (SAP) utilizes the framework established by Generally Accepted Accounting Principles (GAAP). The NAIC’s guidance on SAP (defined in the Accounting Practices and Procedures Manual) is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting. Those GAAP Pronouncements that are not applicable to insurance companies will not be adopted by the NAIC. For GAAP Pronouncements that do not differ from SAP, the NAIC may specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC. Future SAP Pronouncements will specifically identify any GAAP Pronouncements that are to be included in SAP whether in whole, in part, or with modification as well as any GAAP Pronouncements that are rejected. Future GAAP Pronouncements, which SAP has not yet addressed, shall not be considered as providing authoritative statutory guidance.

As illustrated by the previous paragraph, the NAIC believes it is important to comment on GAAP exposure drafts that will affect SAP before such guidance is finalized. Exposing potentially contentious issues to the applicable GAAP bodies before completion will create a more efficient and effective maintenance process for the Statutory Accounting Principles (E) Working Group (SAPWG). In addition, this also allows the NAIC to be proactive to GAAP rather than reactive under the current system.

Comments on exposed GAAP Pronouncements affecting financial accounting and reporting will be developed at the discretion of the SAPWG chair. After the comment letter has been agreed to by the SAPWG, the chair of the Accounting Practices and Procedures (E) Task Force and the Financial Condition (E) Committee must review and approve the letter before it is sent to the applicable GAAP body. Every reasonable attempt will be made to provide an adequate comment period to interested parties; however, FASB/American Institute of Certified Public Accountants (AICPA) deadlines may inhibit exposure in every instance. The chair will consider factors such as comment deadline and level of controversy surrounding the issue. The chair of the parent task force and Committee may override such decision at any time.

Comments on exposed Pronouncements promulgated by the AICPA will be developed at the discretion of the NAIC/AICPA Working Group chair. The chair may defer comment to the SAPWG if the pronouncement affects financial accounting guidance. After the comment letter has been agreed to by the NAIC/AICPA Working Group, the chair of the Financial Condition (E) Committee must review and approve the letter before it is sent to the applicable GAAP body. Every reasonable attempt will be made to provide an adequate comment period to interested parties, however FASB/AICPA deadlines may inhibit exposure in every instance. The chair will consider factors such as comment deadline and level of controversy surrounding the issue. The chair of the parent Committee may override such decision at any time.

These comment letters may be considered during the maintenance of finalized GAAP Pronouncements by the SAPWG (as defined in the NAIC Policy Statement on Maintenance of Statutory Accounting Principles). Nevertheless, these letters will not bind the SAPWG to its tentative position during its deliberation to adopt, modify or reject the final GAAP guidance.
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NAIC Policy Statement On Statutory Accounting Principles
Maintenance Agenda Process

The purpose of the following Policy Statement is to document the Statutory Accounting Principles (E) Working Group (SAPWG) maintenance agenda process.

As acknowledged in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The SAPWG shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The Emerging Accounting Issues (E) Working Group will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Information and issues can be presented to the SAPWG in a variety of ways. Issues can be recommended or forwarded from other NAIC working groups or task forces, or from interested parties. Also, if any guidance within the Generally Accepted Accounting Principles (GAAP) Hierarchy (see § IV of the Preamble to the Accounting Practices and Procedures Manual) is added or revised, those changes must be considered by the SAPWG. In order for an issue to be placed on the Pending List, the recommending party must complete a Statutory Accounting Principles Maintenance Agenda Submission Form (Form A) and submit it to the NAIC SAPWG support staff no later than 20 business days prior to the next scheduled SAPWG meeting. The NAIC staff will prepare a submission form for all GAAP pronouncements that have not been previously addressed by the SAPWG. NAIC staff will update the Pending List before each National Meeting and will notify the recommending party of such action. If the SAPWG does not wish to address the issue (e.g.; issue deemed not applicable to statutory accounting) or rejects the position presented, then the item is moved to the Rejected Report. Should the SAPWG choose to address an issue, it is moved to either the Substantive or Nonsubstantive Listings.

The Substantive Listing are items that require a new issue paper and SSAP to address the issue. Once items are placed on this listing, they are prioritized and the formal maintenance policy is followed (see *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*). The SAPWG will utilize the NAIC website for exposure of substantive items. The Nonsubstantive Listing contains items that are considered editorial or technical in nature and therefore a new SSAP will not be developed. In other words, a revision to a SSAP for these items will not be deemed to modify its conclusion or original intent. The Rejected Report identifies all the items that were proposed to the SAPWG and rejected or deemed not applicable to statutory accounting. The Active Report identifies items that are in the process of completion. The Active Report is prioritized and shows the status of issue papers and SSAPs. The Disposition Report captures the conclusions of the SAPWG.

It should be noted that this Policy Statement addresses the process and the flow of information. The timing is left to the discretion of the SAPWG. For instance, an item can move from the pending list to the substantive disposition report in one, two or three National Meetings.

The NAIC staff will maintain a current Maintenance Agenda on the NAIC website at www.naic.org. Attachment A to this Policy Statement includes a flowchart depicting the flow of information. Attachment B includes a blank Form A. Attachment C is an example the document that will be attached to all exposed documents and will serve as the notice of public hearing and request for written comments.
Appendix F
Attachment B

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue:

Check (applicable entity):

<table>
<thead>
<tr>
<th>Correction of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Description of Issue:

*Existing Authoritative Literature:

*Activity to Date (issues previously addressed by SAPWG, Emerging Accounting Issues WG, SEC, FASB, other State Departments of Insurance or other NAIC groups):

*Information or issues (included in Description of Issue) not previously contemplated by the SAPWG:

Recommended Conclusion or Future Action on Issue:

Recommending Party:

(Organization)

(Person Submitting, Title)

(Address, City, State, ZIP)

(Phone and E-mail Address)

(Date Submitted)

* Indicates required information before NAIC staff will accept form as a final document.
Notice of Public Hearing and Request for Written Comments

Hearing Date: ______________ Location: ______________
Deadline for Written Notice of Intent to speak: ______________ Deadline for Receipt of Written Comments: ______________

Basis for hearings. The Statutory Accounting Principles (E) Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by . Speakers will be notified as to the date, location, and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by ______________. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below. Comments can also be submitted by electronic mail to ______________@naic.org.

Format of the hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure Drafts can be obtained on the Internet at the NAIC Home Page (http://www.naic.org). The documents can be downloaded using Microsoft Word or WordPerfect.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments to ______________ at the address listed below, no later than ______________. Comments can also be submitted by electronic mail to ______________@naic.org. Electronic submission followed by signed hardcopy is preferred. After they have been reviewed by the SAPWG, these letters will be available for public inspection and may be obtained by contacting the NAIC Insurance Products and Services Division (816) 783-8300.

National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604 (816) 842-3600
NAIC Policy Statement on Emerging Accounting Issues Agenda Process

The purpose of the following Policy Statement is to document the Emerging Accounting Issues (E) Working Group (EAIWG) agenda process.

As acknowledged in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles (E) Working Group shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The EAIWG will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Information and issues can be presented to the EAIWG in a variety of ways. Issues can be recommended or forwarded from other NAIC working groups or task forces, from interested parties or from the NAIC staff. In order for an issue to be placed on the Agenda, the recommending party must complete an Emerging Accounting Issues (E) Working Group Agenda Submission Form (Form B) and submit it to the NAIC staff no later than 20 business days prior to the next scheduled EAIWG meeting. NAIC staff will update the Agenda before each National Meeting and will notify the recommending party of such action. Every issue taken up by the EAIWG must be discussed at no less than two open meetings with opportunity for interested parties to present comments. The NAIC website will be utilized for such exposures. The website will maintain the applicable Form B and the tentative consensus opinions. Final consensus opinions will be published annually in Appendix B to the *Accounting Practices and Procedures Manual*. The guidance contained in the consensus opinions of the EAIWG will become effective upon publication unless otherwise stated in the opinion.

Exhibit A includes a blank Form B.
Emerging Accounting Issues (E) Working Group
Agenda Submission Form
Form B

Issue:

*Description of Transaction/Event/Issue:

*Accounting Issues:

*Authoritative Literature (excerpt applicable references):

*Activity to Date (issues previously addressed by Statutory Accounting Principles WG, Emerging Accounting Issues WG, SEC, FASB, other State Departments of Insurance or other NAIC groups):

*Recommended Conclusion or Future Action on Issue:

+NAIC Staff Recommendation:

Recommending Party:

(Organization)

(Person Submitting, Title)

(Address, City, State, ZIP)

(Phone and E-mail Address)

+NAIC Staff Review Completed by:

(Date Submitted)

* Indicates required information before NAIC staff will accept form as a final document
+ NAIC Staff will complete before presentation to the EAIWG

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Appendix F


The purpose of the following Policy Statement is to document the process and procedure for identifying the impact of Statements of Statutory Accounting Principles (SSAP) on NAIC publications.

As referenced in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles (E) Working Group (SAPWG) shall have the exclusive responsibility of developing and proposing new SSAPs. The Emerging Accounting Issues (E) Working Group will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

An SSAP can affect the various NAIC publications in many different ways. New accounting practices or procedures may result in new disclosures and reporting requirements (affecting Annual Statement Blank and Instructions), modified analysis techniques (affecting RBC formula or IRIS ratios), or new examination procedures (affecting Examiners Handbook).

The SAPWG shall evaluate the impact that newly adopted SSAPs will have on other NAIC publications. To that end, the SAPWG will complete a SSAP Impact on NAIC Publications form after adoption of every SSAP. This form will be used to evaluate the impact of the SSAP, and to recommend a modification as the SAPWG deems appropriate. The SAPWG may seek the assistance of NAIC staff or interested parties in drafting specific language for the affected publication.

After completion of the form, it will be forwarded with a recommendation to the affected working group or task force. The NAIC staff will update the SAPWG as to the progress of the recommendation.

Exhibit A includes a blank SSAP Impact on NAIC Publications form.
SSAP Impact on NAIC Publications Form

SSAP No. and Title:

<table>
<thead>
<tr>
<th>Affected NAIC Publication(s) (check):</th>
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<tbody>
<tr>
<td>Accreditation Standards</td>
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<tr>
<td>Actuarial Opinion</td>
<td></td>
</tr>
<tr>
<td>Annual Statement Blank</td>
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<tr>
<td>Annual Statement Instructions</td>
<td></td>
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<tr>
<td>Financial Analysis Handbook</td>
<td></td>
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<tr>
<td>Financial Condition Examiners Handbook</td>
<td></td>
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<tr>
<td>IRIS Ratio Results</td>
<td></td>
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<tr>
<td>Model Laws, Regulations and Guidelines</td>
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<tr>
<td>RBC Formula</td>
<td></td>
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<tr>
<td>SVO Purposes &amp; Procedures Manual</td>
<td></td>
</tr>
<tr>
<td>Other: ____________________________</td>
<td></td>
</tr>
</tbody>
</table>

Background and Description of SSAP:

______________________________

Issues Affecting NAIC Publication(s)

______________________________

Specific Recommendation or Future Action on Issue (attached separate sheet if necessary):

______________________________

Recommending Party:

Statutory Accounting Principles (E) Working Group

______________________________
(Chair)

______________________________
(Date Adopted by SAPWG)
NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Annual Statement Blank

The purpose of the codification of statutory accounting principles (SAP) project was to produce a comprehensive guide to SAP for use by insurance departments, insurers, and auditors. Statutory accounting principles, as they existed prior to codification did not always provide a consistent and comprehensive basis of accounting and reporting. Insurance companies were sometimes uncertain about what rules to follow and regulators were sometimes unfamiliar with the accounting rules followed by insurers in other states. This was due in part to the fact that prior to codification, accounting guidance could be found in the NAIC Accounting Manual, Annual Statement Instructions, Examiners Handbook, and various states’ laws and regulations. As a result, insurers’ financial statements were not prepared on a comparable basis. Now that accounting requirements have been more rigidly stipulated by the NAIC, it is imperative that the accounting requirements and the reporting and disclosure requirements remain synchronized. This is an excellent opportunity to create a system of parallel requirements. This effort has already been recognized by the NAIC/AICPA Working Group. In 1999, the working group modified the Model Regulation Requiring Annual Audited Financial Reports to require the following for audited financial statements:

Notes to financial statements. These notes shall be those required by the appropriate NAIC Annual Statement Instructions and the NAIC Accounting Practices and Procedures Manual. The notes shall include a reconciliation of differences, if any, between the audited statutory financial statements and the annual statement filed pursuant to Section [insert applicable section] of the [insert state] insurance law with a written description of the nature of these differences.

As stated in the model regulation, the NAIC/AICPA Working Group has an expectation that the requirements of the Annual Statement Instructions and the Accounting Practices and Procedures Manual will be identical in all pertinent parts that are subject to audit. There is no reason to create a different set of audit requirements in the Annual Statement Instructions when a complete and comprehensive guide to statutory accounting exists. However, it must be noted that the Statements of Statutory Accounting Principles (SSAPs) are not intended to prescribe the specific format of the detailed financial statements.

The scope of this Policy Statement is defined as follows:

Any change to the annual statement core financials (balance sheet, income statement, cash flow and notes to the financial statements) must reviewed by the Statutory Accounting Principles (E) Working Group to determine whether it conflicts with the disclosure requirements of the SSAPs.

The scope is defined in broad terms because it is very difficult to specify what constitutes a conflict with the SSAPs. For example, the renumbering of the assets page does not conflict because there is not a SSAP that prescribes the order of asset presentation. Contrast this with a seemingly innocuous proposal to modify column 23 of Schedule P - Part 1 (salvage and subrogation anticipated) that would create a disclosure conflict with SSAP No. 55, paragraph 12.

In order to ascertain that the requirements of the Annual Statement Instructions and Blank are in harmony with the SSAPs (as they relate solely to the core financial statements), the following procedures shall be followed:
1. The Blanks Agenda Item Submission Form will include an interrogatory that will indicate to the Blanks (E) Working Group whether the proposal:
   a. Affects the core financial statements
   b. Conflicts with an existing SSAP
   c. Is not currently required by a SSAP
   d. Has been reviewed by the Statutory Accounting Principles (E) Working Group

2. One staff member from the Statutory Accounting Principles (E) Working Group and the Blanks (E) Working Group are charged with verifying the accuracy of the interrogatory proposed in (1) above. After the staff reviews the proposals, they will report their findings back to the applicable groups before each quarterly meeting of the Blanks (E) Working Group. If the staff identifies issues that need further exploration or consultation, the chairs of the two groups or certain members from each group will hold a joint meeting before the quarterly meeting.

3. The Blanks (E) Working Group will reject proposals that will delete/modify information contained within the core financial statements that are required by an existing SSAP.

4. The Blanks (E) Working Group will either reject proposals that would require additional audited disclosure or audited information within the core financial statements if that same item is not required by an existing SSAP; or move it outside the core financial statements. The sponsoring party will still have the option of placing this information outside the core financial statements (e.g., general interrogatories or interrogatories to schedules) until the disclosure is included in a SSAP. If the disclosure were added to a SSAP in the future, it could be moved to the Notes to the Financial Statements and subject to audit at that time.

5. The NAIC will maintain a SSAP to Annual Statement cross-reference. This cross-reference will contain two significant features. First, it will list all of the SSAP disclosures and reference them to where in the Annual Statement the disclosure requirement is met. Second, the cross-reference will identify the Annual Statement components that are required by a SSAP. The cross-reference can be used by the Blanks (E) Working Group and interested parties in completing the new Blanks Agenda Item Submission Form Interrogatory.

The procedures included in this Policy Statement represent a significant change in the current process, but can only result in increased coordination between the Accounting Practices and Procedures (E) Task Force and the Blanks (E) Working Group. This coordination can only give rise to more consistent, meaningful guidance to the regulators, companies and auditors.
IMPLEMENTATION GUIDE (Guide) for the
ANNUAL FINANCIAL REPORTING MODEL REGULATION (Model)

The new requirements within the Annual Financial Reporting Model Regulation related to auditor independence, corporate governance and internal control over financial reporting became effective in 2010. The Implementation Guide is being published to assist companies in planning and preparing for compliance with the new requirements.

The Implementation Guide (Guide) is intended to supplement the Model, not to create additional requirements, by providing interpretive guidance and clarifying the meaning of terms used in the Model. Such guidance is important to ensure common understanding between insurers and regulators and to memorialize the intent of the changes. Because issues and questions will occur from time-to-time, by placing the Guide outside of the Model, maintenance can be achieved in a cost effective way without reopening the Model especially when the issue under consideration is an interpretation of the requirements. The Guide should not be viewed as a requirement of complying with the Accounting Practices and Procedures Manual.

Maintaining the Guide

The responsibility of developing and maintaining the Guide resides with the NAIC/AICPA Working Group with changes to the Guide following the NAIC regulatory due process. The Guide resides as an informational appendix to the NAIC Accounting Practices & Procedures Manual (AP&P Manual). The AP&P Manual was selected as the logical repository since the Guide provides instruction about compliance with the Model, which directly relates to financial reporting and statutory accounting.

The regulatory due process for modifying this Guide requires the NAIC/AICPA Working Group to send adopted proposals to the Accounting Practices and Procedures (E) Task Force for adoption and inclusion in the AP&P Manual. If the Accounting Practices & Procedures Task Force recommends substantive changes to the proposal received from the NAIC/AICPA Working Group, the proposal should be returned to the NAIC/AICPA Working Group for further deliberation.
Appendix G  Implementation Guide

Table of Contents

The Table of Contents for the Guide mirrors that of the Model. However, not all sections of the Model require interpretive guidance. Consequently, only those sections containing guidance are contained in the Guide. The presentation of the Guide is organized by the Section Title with the Section number of the Model appearing after the title.

<table>
<thead>
<tr>
<th>Title</th>
<th>Section</th>
<th>Page</th>
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<tr>
<td>Definitions</td>
<td>3</td>
<td>2</td>
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<td>General Requirements Related to Filing and Extensions for Filing of Annual Audited Financial Reports and Audit Committee Appointment</td>
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<td>Qualifications of Independent Certified Public Accountant</td>
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<td>Management’s Report of Internal Control over Financial Reporting</td>
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</tr>
<tr>
<td>Appendix 1</td>
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</table>

Definitions (Section 3)

Certain terms and definitions contained in the Model need no further explanation. The Guide provides additional information for preparers and users for some definitions to facilitate their understanding.

“Audited financial report” (D), differs from the term “financial statements” in that the Audited financial report (see Section 5 of the Model) includes the financial statements plus the report of the independent certified public accountant. “Financial statements,” therefore, excludes the report of the independent certified public accountant.

“Group of insurers” (H), as intended for use in the Model is to recognize the variety of structures that may exist. Companies within a holding company structure, or other set of insurers identified by management, may often share common management, systems or processes. Consequently, when management asserts to the effectiveness of their internal controls, it is appropriate to make such an assertion for those companies based upon the organization management determines to be most relevant to meet the reporting requirements. Because holding company structures, and other groups of insurers, can be complex and organized to meet corporate objectives, that structure may not align with the organizations that are responsible for managing and preparing the financial statements of the insurer. The Model provides flexibility to insurers to identify a “Group of insurers” for purposes of evaluating the effectiveness of their internal control over financial reporting. In determining the appropriate scope and level of testing for systems that are shared by a group of insurers, management is not required to expand the scope or perform additional testing that would be redundant for each legal entity included within the group of insurers. To the extent that a specific internal control or system is unique to and has a material impact on the preparation of the audited statutory financial statements of a legal entity included in a group of insurers and the legal entity exceeds the premium thresholds contained in Section 16, that control or system is to be included in management's evaluation of internal controls.
A “Group of insurers” that has been granted approval to file audited statutory consolidated or combined financial statements of a group of insurers (as described in Section 8) may set the scope and level of testing for purposes of determining effectiveness of internal controls over financial reporting consistent with the basis on which the audited statutory financial statements for the Group are prepared (i.e., at the combined or consolidated level).

The following example is intended to illustrate various ways that a “Group of insurers” could be determined. The example is not intended to be limiting in any way. Rather, it is intended to show the flexibility to be in compliance with the Model. Insurers are encouraged to notify the Commissioner of its initial “Group of insurers” and any subsequent changes to such group.

1. “Group of insurers” could be established at the ultimate parent level, i.e., one report of the effectiveness of internal controls for all insurers in the group-insurance companies 1-6.
2. Two “Group of insurers” could be established at the holding company level, i.e., holding company A and B. In this case, a separate report would be required for holding company A, holding company B, and if it met the reporting threshold, insurance company 4 since it is not in either group.
3. Two “Group of insurers” could be established based upon the type of insurance company, i.e., LA&H companies 1, 4 and 6 could be one group and HMO companies 2 and 3 in the second group. In this case, a separate report would be required for the LA&H companies, the HMO companies and if it met the reporting threshold, insurance company 5 since it is not in either group.
4. Two “Group of insurers” could be established based upon the way the entities are managed. For example, companies, 1, 2, 3 and 5 have the same management while companies 4 and 5 have common management.
5. If management elects not to identify a “Group of insurers” for purposes of evaluating the effectiveness of internal control over financial reporting then each reporting entity meeting the reporting requirements of Section 16 would prepare such a report.
“Internal control over financial reporting” (I), as defined in the Model is intended to have the same meaning as understood in the public sector to comply with the requirements of the Sarbanes-Oxley Act of 2002. Because some terms might not be fully defined and to avoid misunderstanding, this Guide attempts to clarify such terms. For example, the word “reliability” used in the phrase “reliability of financial statements” has the same meaning as that contained in the generally accepted accounting principles (GAAP) framework, Statement of Financial Accounting Concepts Two. This Statement is referenced in the Preamble, Part III, paragraph 24 of the AP&P Manual.

General Requirements Related to Filing and Extensions for Filing of Annual Audited Financial Reports and Audit Committee Appointment (Section 4)

Section 4D stipulates that each insurer required to file an annual Audited financial report pursuant to the Model shall designate a group of individuals as constituting its Audit committee. Section 4D further states that the Audit committee of an entity that controls an insurer may be deemed to be the insurer’s Audit committee for purposes of this regulation at the election of the controlling person. The definition of Audit committee in Section 3 of the Model references Section 14E for exercising this election. However, a disclaimer within Section 14 of the Model indicates that the section shall not apply to SOX Compliant Entities or wholly-owned subsidiaries of SOX Compliant Entities. Regardless of the disclaimer, in order to comply with the second sentence in Section 4D, the Audit committee of any entity that controls an insurer (a SOX Compliant entity or a non-SOX Compliant Entity) may be deemed to be the insurer’s Audit committee at the election of the controlling person, and only if such election is completed in the manner outlined in Section 14E.

The responsibility of the Audit committee is defined in Section 14 of the Model. Section 14 states that each member of the Audit committee shall be a member of the Board of Directors and sets forth the requirements for the proportion of independent Audit committee members based on the insurer’s direct written and assumed premiums. The definition of an independent Audit committee member is outlined in Section 14.

Qualifications of Independent Certified Public Accountant (Section 7)

Lead Audit Partner Rotation Requirement (Section 7D)

Purpose
The purpose of this section is to provide companies and their independent accountants with guidance to enable an orderly transition in meeting the revised lead audit partner rotation requirements as set forth in Section 7.

Background
Section 7 provides certain limitations on the number of years an audit partner may serve in the capacity of lead audit partner for an insurance company audit. Previously, the lead audit partner was permitted to serve for seven consecutive years in that capacity with a two year break in service. Under the revised Model “…the lead …audit partner (having primary responsibility for the audit) may not act in that capacity for more than five (5) consecutive years. The person shall be disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of five (5) consecutive years.”

The new rotation requirements under Section 7 are effective beginning with audits of the 2010 financial statements. The rotation requirements of the Model and the interpretative guidance provided are applicable for statutory reporting and regulatory purposes. An insurer and its affiliates that are subject to the rotation requirements of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) must also continue to comply with those rotation requirements.
Relief from the Lead Audit Partner Rotation Requirement (Section 7D)

The Model states:

An insurer may make application to the Commissioner for relief from the above rotation requirement on the basis of unusual circumstances. This application should be made at least thirty (30) days before the end of the calendar year. The Commissioner may consider the following factors in determining if the relief should be granted:

(a) Number of partners, expertise of the partners or the number of insurance clients in the currently registered firm;

(b) Premium volume of the insurer; or

(c) Number of jurisdictions in which the insurer transacts business.

The following examples illustrate circumstances that the Commissioner may consider in determining if relief from the lead partner rotation requirement shall be granted:

1. No other partners in the firm’s local office have the qualifications to serve as lead audit partner and the use of a qualified partner resident in another location could result in increased audit risk and higher audit fees.

2. Limited number of partners in the firm that have the qualifications to serve as the lead audit partner.

3. Switching firms could result in increased audit risk due to the new engagement team’s lack of familiarity with the insurer.

4. Limited availability of other firms in a particular location with the requisite expertise.

5. The regulator believes that complex issues at an insurer make a particular partner best suited to continue as lead audit partner

6. Short-term relief due to the occurrence of an unforeseeable event that renders a partner unable to continue as the lead audit partner on the engagement.

7. Short-term relief due to unexpected delays in the state’s licensing or admission process that prevent the “new” lead audit partner from assuming that role.

Also, the granting of transitional relief may be warranted when the non-insurance parent or ultimate parent of an insurance company is an SEC registrant and the current lead audit partner on the SEC registrant has completed his or her rotation as the lead audit partner on insurance subsidiaries prior to completing his or her five-year rotation as the lead partner on the audit of the GAAP financial statements of the SEC registrant. In this situation the relief would allow the lead audit partner to complete his or her rotation on the SEC registrant as long as he or she no longer acts in the capacity of lead audit partner for any insurance subsidiaries and/or any downstream affiliates of the insurance subsidiaries.

Frequently Asked Questions (Section 7D)

Following are a series of frequently asked questions to assist companies and their independent accountants in interpreting this guidance. Dates provided refer to the year of financial statements under audit.

In determining when the lead audit partner must rotate, consecutive time served in the capacity of lead audit partner prior to the effective date of these rules would be counted (i.e., the lead audit partner is not afforded a “fresh start”). If the lead audit partner completed the two year break in service required by the previous version of the Model prior to the effective date of these rules, the partner is eligible to resume service as a lead audit partner for a five year period and need not wait additional years to accomplish a five year break in service.
1. 2010 would be the fifth year that a partner would serve as lead audit partner of an insurance company. Would that partner be able to complete the 2010 year end audit?

Yes. The partner would be able to complete the 2010 year end audit; however, the partner would be required to rotate off the engagement after the 2010 year end audit.

2. 2010 would be the sixth or seventh year that a partner would serve as the lead audit partner. Would that partner be able to serve in that capacity for the 2010 audit?

No. The partner would be required to rotate off for the 2010 year end audit. In determining when the lead audit partner must rotate, consecutive time served in the capacity of lead audit partner since the most recent two year break in service prior to the effective date of these rules would be counted.

3. If a partner serves as the concurring partner from 2007 – 2010, can that partner serve as the lead audit partner in 2011? If so, for how many years?

Yes. The Model does not prohibit a partner that has served as the concurring partner from subsequently serving as the lead audit partner. The time served as concurring partner does not count towards the five year limitation. In the situation above, the partner would be permitted to serve as lead audit partner from the 2011 year end audit through the 2015 year end audit.

4. Can a lead audit partner serve as the concurring review partner during the required five year break in service?

Yes. The Model specifies that a partner may not act in “that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of five (5) consecutive years” where “that” refers to the role of lead audit partner. Therefore, the Model does not prohibit that partner from serving as concurring partner during that partner’s five year break in service.

5. During the five-year break in service, can a partner serve as lead audit partner on an insurance company affiliate of that company?

No. The Model specifies a “person shall be disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of five (5) consecutive years.” The phrase “insurance subsidiaries or affiliates” is interpreted to mean any subsidiaries and affiliates (whether insurance or non insurance).

6. If a lead audit partner serves for six years prior to the effective date of the revised Model (year end audits from 2003 – 2008) then rotates off the engagement for two years (year end audits 2009 – 2010), can that partner serve for five additional consecutive years (year end audits from 2011 – 2015) as the lead audit partner?

No. The requirement for a break in service of five consecutive years becomes effective for the 2010 year end audits. If the partner has not completed the two year break in service prior to the effective date of the new requirement, the partner becomes subject to the new requirement and must complete a five year break in service. However, if the lead audit partner completes the two year break in service by 2009 instead of 2010, that partner would be permitted to resume the lead audit partner role in 2010.

7. A partner that served seven years as lead audit partner has not worked on the engagement for two years. Assuming 2010 otherwise would be year three of the break in service, can that partner assume the lead audit partner role for the 2010 year end audit?
Yes. The requirement for the five year break in service starts with engagement years beginning 2010. Prior to 2010, the rotation requirement is for a two year break in service.

8. If a lead audit partner served in that capacity for years 2007 – 2009 and was not on the engagement (or that of any subsidiary or affiliate) for 2010, would that partner have to complete a five year break in service before again serving as the lead audit partner?

No. However, the partner could only serve as the lead audit partner for two more years since the partner has already served three years on this engagement.

9. Can a former lead audit partner currently in a break in service continue to serve the client in a role other than the lead audit partner, for example concurring partner or auxiliary partner, such as tax review partner or other assisting role?

Yes. The Model auditor rotation rules apply only to the role of lead audit partner on the audit of the insurance company and its insurance subsidiaries or affiliates.

10. 2010 is the first year that a partner serves as the lead audit partner on an insurer. The partner serves as the lead audit partner on that insurer for year end audits of 2010 – 2012, however, during 2013 – 2015 that partner does not serve as the lead audit partner on that insurer or any of its affiliates. If that partner again serves the insurer (or any of its insurance subsidiaries or affiliates) as the lead audit partner for 2016 year end audit, when must that partner rotate off the engagement?

The partner is permitted to serve as the lead audit partner for the 2016 and 2017 year end audits and must begin a five year break in service with the year end 2018 audit. The break in service during 2013 – 2015 would be for less than the five-year period required by the Model. In order for the partner to be permitted to begin a new five-year service period as lead audit partner on the insurer or any of its insurance subsidiaries or affiliates, a full five-year break in service is required to be completed by that partner.

11. How is service as the lead audit partner on the audit of the GAAP-basis financial statements of a separate account evaluated under the Model?

A separate account is not a legal entity, but an accounting entity with accounting records for variable contract assets, liabilities, income, and expenses segregated as a discrete operation within the insurance company. Therefore, the separate account is considered to be an insurance affiliate for purposes of applying the Model.

If the insurer is a part of a mutual fund complex, the mutual funds are considered to be non insurance affiliates even if held as investments in the insurer’s separate accounts.

12. An insurer changes to a new independent accounting firm. At the same time, the lead audit partner for that insurer joins the new independent accounting firm. Would the lead audit partner’s time at the previous accounting firm count toward the five year rule at the new accounting firm?

Yes. The rule specifically applies to the lead audit partner and not the independent accounting firm.
13. Some firms have individuals that are CPAs but not partners (i.e., nonequity participants such as directors or principals) that serve in the role of the lead audit partner. Can such a CPA serve in the role of the lead audit partner of an insurance company?

Yes. The Model defines the lead audit partner as the individual having “primary responsibility for the audit.” Whether this capacity is served by a partner or other CPA with the equivalent qualifications is at the discretion of the independent accounting firm. As such, the individual would be subject to the rotation requirements of the lead audit partner under Section 7.

Questions 14 through 23 are based on the following hypothetical fact pattern and assume there are no public registrants in the group.

Neither insurance subsidiary A nor insurance subsidiary B has any investment in non insurance subsidiary C.

- Partner Smith served as the lead audit partner on non insurance holding company H for six years through the 2010 year end audit.
- Partner Jones served as the lead audit partner on insurance subsidiary A for four years through the 2010 year end audit.
- Partner Little served as the lead audit partner on insurance subsidiary B for three years through the 2010 year end audit.
- Partner Brown served as the lead audit partner on non insurance subsidiary C for two years through the 2010 year end audit.
- Partner Miller served as the lead audit partner on insurance subsidiary D for three years through the 2010 year end audit.
- Partner King served as the lead audit partner on non insurance subsidiary E for seven years through the 2010 year end audit.

14. Can Partner Smith rotate from serving as the lead audit partner on non insurance holding company H to serving as the lead audit partner on insurance subsidiary B for the 2011 year end audit?

Yes. The limitation under Section 7 initiates with service as the lead audit partner of an insurer. Assuming Partner Smith has not previously served as the lead audit partner on an insurer, he or she can then serve as the lead audit partner on insurance subsidiary B or any of its affiliates for up to five years.

15. Can Partner King rotate from serving as the lead audit partner on non insurance subsidiary E to serving as the lead audit partner on insurance subsidiary B for the 2011 year end audit?

Yes. The limitation initiates with service as the lead audit partner of an insurer. Assuming Partner King has not previously served as the lead audit partner on an insurer, he or she can then serve as the lead audit partner on insurance subsidiary B or any of its affiliates for up to five years.

16. Can Partner Brown rotate from serving as the lead audit partner on non insurance subsidiary C to serving as lead audit partner on insurance subsidiary B for the 2011 year end audit?

Yes. The limitation initiates with service as the lead audit partner of an insurer. Assuming Partner Brown has not previously served as the lead audit partner on an insurer, he or she can then serve as the lead audit partner on insurance subsidiary B or any of its affiliates for up to five years. Therefore, Brown could serve insurance subsidiary B for five years beginning with the 2011 year-end audit.
17. Can Partner Brown rotate from serving as the lead audit partner on non insurance subsidiary C to serving as lead audit partner on Holding Company H for the 2011 year end audit? 

Yes. C is a non insurance subsidiary and H is a non insurance holding company; therefore, assuming Partner Brown has not previously served as the lead audit partner on an insurer, the partner rotation requirements of Section 7 are not applicable relative to non insurance subsidiary C and non insurance holding company H.

18. Can Partner Jones rotate from serving as the lead audit partner on insurance subsidiary A to serving as the lead audit partner for insurance subsidiary B for the 2011 year end audit? 

Yes. However, Jones can only serve for one year due to four years prior service as the lead audit partner on insurance subsidiary A (an insurance affiliate).

19. Can Partner Jones rotate from serving as the lead audit partner on insurance subsidiary A to serving as the lead audit partner on non insurance subsidiary C for the 2011 year end audit? 

Yes. However, Jones can only serve for one year due to four years prior service as the lead audit partner on insurance subsidiary A (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.

20. Can Partner King rotate from serving as the lead audit partner on non insurance subsidiary E to serving as the lead audit partner on non insurance subsidiary C for the 2011 year end audit? 

Yes. E is a non insurance subsidiary and C is a non insurance subsidiary; therefore, assuming Partner King has not previously served as the lead audit partner on an insurer, the partner rotation requirements of Section 7 are not applicable relative to non insurance subsidiary E and non insurance subsidiary C.

21. Can Partner Jones rotate from serving as the lead audit partner on insurance subsidiary A to serving as the lead audit partner on non insurance subsidiary E for the 2011 year end audit? 

Yes. However, Jones can only serve for one year due to four years prior service as the lead audit partner on insurance subsidiary A (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.

22. Can Partner Jones rotate from serving as the lead audit partner on insurance subsidiary A to serving as the lead audit partner on insurance subsidiary D for the 2011 year end audit? 

Yes. However, Jones can only serve for one year due to four years prior service as the lead audit partner on insurance subsidiary A (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.

23. Can Partner Little rotate from serving as the lead audit partner on insurance subsidiary B to serving as the lead audit partner on non insurance subsidiary E for the 2011 year end audit? 

Yes. However, Little can only serve for two years due to three years prior service as the lead audit partner on insurance subsidiary B (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.
Appendix G  Implementation Guide

Prohibited Services (Section 7 G)

The Model does not allow the Commissioner to accept an Audited financial report prepared by an accountant who provides the insurer, contemporaneously with the audit, non-audit services as outlined within the Model. One of the prohibited services outlined in the Model consists of bookkeeping or other services related to the accounting records or financial statements of the insurer. The prohibition in this area should include, but is not limited to, services related to the preparation of the Annual Statement to be submitted by the insurer. However, the drafting of the Audited financial report would not be prohibited, provided that the accountant does not assume decision-making authority (e.g., approval of journal entries) in compiling the draft report.

Communication of Internal Control Related Matters Noted in an Audit (Section 11)

In addition to the annual Audited financial report, each insurer must furnish the Commissioner with a written communication as to any unremediated material weakness in its internal control over financial reporting noted during the audit. The communication is prepared by the accountant within 60 days after the filing of the annual Audited financial report and is filed by the insurer. Recognizing it may not always be practical, insurers are encouraged to file the communication concurrently with the filing of the annual Audited financial report for those years in which the insurer is aware that a financial condition examination has been scheduled. The insurer is required to provide a description of remedial actions taken or proposed to correct unremediated material weaknesses, if the actions are not described in the accountant’s communication.

The Model requires that the Commissioner be notified when unremediated material weaknesses in internal control over financial reporting were noted during the audit. Previous versions of the Model required such communication when any significant deficiencies in internal control over financial reporting were noted during the audit, whether remediated or not. This distinction is important because of the level of severity of the internal control deficiency that is applicable to each term. The terms “material weakness” and “significant deficiency” have the same meaning respectively as used in PCAOB or American Institute of Certified Public Accountants (AICPA) auditing literature - PCAOB Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting That is Integrated With an Audit of Financial Statements or AICPA AU Section 325, Communicating Internal Control Matters Identified in an Audit (see Section 16E of this Guide for the definitions of material weakness and significant deficiency that are included in the auditing literature). However, the insurer is expected to maintain information about significant deficiencies that were communicated by its auditors and such information should be available for review during the financial condition examination.

The following is an example of the type of communication that an insurer should prepare to communicate the remedial actions taken or proposed to correct a material weakness in its internal control over financial reporting noted during an audit.

Communication of Internal Control Related Matter Noted in an Audit - Sample

Honorable Commissioner
State of Domicile Insurance Department
State of Domicile

Dear Honorable Commissioner:

During the audit completed for the year ended December 31, 20XX, for XYZ Holding Company Inc ("XYZ"), a material weakness was noted in XYZ’s internal control over financial reporting related to the calculation of insurance reserves. Due to the manner in which the data for homeowners policies are captured by the systems used in its Southeastern US regional office, changes in XYZ’s estimate of
insurance reserves for certain policies are not reviewed by XYZ’s Actuarial Department prior to being recorded in the company’s accounting records.

A material weakness is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. In connection with the weakness noted above, XYZ’s management has taken remedial actions to change its procedures for coding policies issued in the states affected so that all homeowners’ policy data are included in the Actuarial Department review of estimate of insurance reserves. This change was effective on July 1, 20XX.

Should you have any questions regarding this matter, please do not hesitate to contact me at the number noted above.

Regards,

XYZ Holding Company, Inc.

Requirements for Audit Committees (Section 14)

A disclaimer within Section 14 of the Model indicates that the section shall not apply to SOX Compliant Entities or wholly-owned subsidiaries of SOX Compliant Entities. This disclaimer was placed within the Model to avoid conflicts between the independence requirements of the Model and those required of public companies under Section 301 of the Sarbanes Oxley Act of 2002. The expectation of regulators in developing this disclaimer was that the same independent Audit committee required of public companies under Section 301 would be deemed to be the insurer’s Audit committee for purposes of this regulation (pursuant to Section 4D of the Model) or would participate in the oversight of the insurers within the group. Therefore, if material weaknesses, significant deficiencies and/or significant solvency concerns are identified at the legal entity level, the independent Audit committee should be involved in addressing these issues, regardless of their materiality at the consolidated, parent company level.

Independence of an Audit Committee Member (Section 14C)

A policyholder would be considered "independent" unless they receive direct compensation from the insurer for other unrelated services.

A person who is otherwise considered independent and also serves on the Board of Directors of a contracting entity (e.g., medical provider, vendors, banks, etc.) is considered independent.

An otherwise non-independent member of the Board of Directors is considered independent for Audit committee purposes if state law requires participation on the Board (e.g., Medical providers) as long as the member is not an officer or employee of the insurer or one of its affiliates.

Notification letter (Section 14E)

In accordance with Section 14E, upon the initial election by the insurer to designate the Audit committee of an entity that controls the insurer as its Audit committee, the insurer shall provide written notification to the Commissioner of the affected insurer. This notification shall identify the controlling entity and the basis for the election. This election remains in effect for perpetuity, until rescinded, at which time written notification would need to be provided to the Commissioner of the insurer. The notification letter should be timely filed with the Commissioner by the ultimate controlling person prior to the issuance of the statutory Audited financial report. However, each of the affected insurers (i.e. those that will have an Audit committee designated by its ultimate controlling person) that is subject to the provisions of Section 14 shall ensure that the notification letter is filed with the Commissioner. Absence such filing, each of the
affected insurers would be individually responsible for complying with Section 14. For example, referring to the “Group of insurers” chart in Section 3, if the ABC Company is the ultimate controlling person and elects to have its Audit committee serve as the Audit committee for insurance company 5, then ABC Company would file the notification letter (insurance company 5 would have to ensure that the notification letter is filed or comply with Section 14 as a single entity). Once submitted, the election remains in effect until rescinded. The following example illustrates the reporting requirement.

The XYZ insurance company (e.g., insurance company 5) is an indirect subsidiary of and controlled by ABC Company. ABC Company has an independent Audit committee comprised of directors of ABC Company. XYZ insurance Company has elected to designate the Audit committee of ABC Company as the Audit committee of XYZ insurance Company for purposes of complying with Audit committee requirements of the Annual Financial Reporting Model Regulation.

(Signed) __________________________________________ (Date) __________
(XYZ Insurance Company Chief Executive Officer)

(Signed) __________________________________________ (Date) __________
(ABC Company Chief Executive Officer)

Transitional Guidance (Section 14G)

Once a company exceeds the requisite thresholds for Audit committee requirements contained in Section 14 of the Model, it is required to comply with the Audit committee requirements by January 1 following one (1) complete calendar year. The following are examples of transitional period requirements.

A: Company surpasses $300 million threshold:

ABC Insurance Company has reached the $300 million requisite threshold in its December 31, 2011 audited statutory statement and therefore will be required to meet “majority (50% or more) member independence” Audit committee requirements by January 1, 2013, providing the company necessary time for recruitment and approvals.

B: Company surpasses $500 million threshold:

ABC Insurance Company has subsequently reached the $500 million requisite threshold in its December 31, 2014 audited statutory statement and therefore will be required to meet the “Supermajority (75% or more) member independence” Audit committee requirements by January 1, 2016.

C: Company drops below threshold amount:

If ABC Insurance Company has penetrated the requisite $500 million threshold and has been in compliance with the requirements but subsequently drops below the $500 million threshold, e.g., $450 million in its December 31, 2018 audited statutory statements, the company would be subject to the “majority (50% or more) member independence” requirement and could reduce the Audit committee independence in 2019. Companies, however, are encouraged to structure their Audit committees with at least a supermajority of independent Audit committee members.

Hardship Waiver (Section 14H)

An insurer may make application to the Commissioner for a waiver from the Section 14 requirements based upon hardship. Examples may include, but are not limited to, requests based on the business type of the entity, the availability of qualified board members, or the ownership (e.g., entities owned by non-profit health systems) or organizational structure of the entity. If the application for a waiver is approved, the insurer would file, with its annual statement filing, the approval for relief from Section 14 with the
states that it is licensed in or doing business in and the NAIC. If the nondomestic state accepts electronic filing with the NAIC, the insurer would file the approval in an electronic format acceptable to the NAIC.

Management’s Report of Internal Control over Financial Reporting (Section 16)

Premium Threshold (Section 16A)

The term “direct written premium” is frequently associated with the property/casualty business. While the Model continues to use the term, it raises the question for other businesses, e.g., life and fraternal, what is the appropriate measure for assessing compliance? The following examples have been developed to illustrate the computation since the starting point is the audited financial statements of the reporting entity, and it is possible that the amount reported may not be consistent with written premium as reported in the regulatory reporting blank.

The annual direct written and assumed premium:
- will be derived from the annual Audited financial report of an individual insurer, as of December 31 immediately preceding
- are generally reported in the Statement of Operations of the Audited Financial Report on an ‘earned’ and a ‘net of reinsurance ceded’ basis
- will be computed by making the following adjustments:

<table>
<thead>
<tr>
<th>P/C, Health and Title entities:</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums earned (Statement of Income in Audited financial report)</td>
<td>A</td>
</tr>
<tr>
<td>Add/Deduct: Change in unearned premium</td>
<td>B</td>
</tr>
<tr>
<td>Add: Reinsurance ceded</td>
<td>C</td>
</tr>
<tr>
<td>Direct written and assumed premium *</td>
<td>D=A+B+C</td>
</tr>
</tbody>
</table>

*Note: direct written and assumed premium would be reduced by any premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program

- A - Premiums earned per the Statement of Income will generally equal the Annual Statement, Page 4.
- B - Change in unearned premium is the difference between the current period amount and the prior year-end amount reported in the liabilities section of the balance sheet. The amount may also be derived from other company prepared exhibits.
- C - Reinsurance ceded may be derived from the notes to the Audited financial report, if disclosed, or other company prepared exhibits or schedules. If the Statement of Income or Statement of Operations separately presents reinsurance ceded, an adjustment is not required.
- D - Must be equal to, or greater than, $500 million in order to be subject to Section 16 reporting.

<table>
<thead>
<tr>
<th>Life and Fraternal entities:</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums earned (Statement of Operations in Audited financial report)</td>
<td>A</td>
</tr>
<tr>
<td>Add: Reinsurance ceded</td>
<td>B</td>
</tr>
<tr>
<td>Direct written and assumed premium</td>
<td>C=A+B</td>
</tr>
</tbody>
</table>
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- A - Premiums earned per the Statement of Operations will generally equal the Annual Statement, Page 4.
- B - Reinsurance ceded may be derived from the notes to the Audited financial report, if disclosed, or other company prepared exhibits or schedules. If the Statement of Operations separately presents reinsurance ceded, an adjustment is not required.
- C - Must be equal to, or greater than, $500 million in order to be subject to Section 16 reporting.

Companies in an RBC Level Event or in Hazardous Financial Condition (Section 16B)

For purposes of this subsection, the phrase “RBC level event” refers to any of the regulatory action levels described in the Risk-Based Capital requirements or the trend test. For example, if the reporting entity’s total adjusted capital is equal to or less than 200% of the required risk-based capital, the result would trigger regulatory action.

Management’s Report of Internal Control over Financial Reporting (Sections 16C & 16D)

Management must annually provide their domiciliary insurance department with a report on internal controls over the statutory financial statement process. Recognizing it may not always be practical, insurers are encouraged to file the report concurrently with the filing of the annual Audited financial report for those years in which the insurer is aware that a financial condition examination has been scheduled. The elements to be included in the report are outlined in 16D.

As outlined in Section 16C, an addendum is required for all reports that rely on a Section 404 Report (Sarbanes-Oxley). The Model states that the Section 404 Report means management’s report on internal control over financial reporting as defined by the SEC and the related attestation report of the independent certified public accountant. However, in 2010, the Dodd-Frank Act exempted non-accelerated SEC filers (those reporting companies that do not meet the definition of either an “accelerated filer” or a “large accelerated filer” under Exchange Act Rule 12b-2.) from the requirement to obtain the related attestation report of the independent certified public accountant. As such, non-accelerated SEC filers may file a Section 404 Report that does not include an attestation report of the independent certified public accountant, along with the appropriate addendum, to fulfill requirements in this area.

Alternately, insurers may utilize a report received as a result of work performed in accordance with Statement of Standards in Attestation Engagements (SSAE) No. 15 in a similar fashion to a Section 404 Report. As such, there are two main types of reports that can be provided:

- Reports from entities that have complied with all required elements of Section 404 of the Sarbanes-Oxley Act (or have received an SSAE No. 15 report) either as a requirement or on a voluntary basis.
- Reports from entities that have not complied with Section 404 of the Sarbanes-Oxley Act (or have not received an SSAE No. 15 report).

Appendix 1 of this guide provides examples of Management’s Report of Internal Controls over Financial Reporting utilizing various facts and circumstances.

Section 16D(2): Management must make an assertion regarding the effectiveness of the insurer’s Internal control over financial reporting to the best of its knowledge and belief after diligent inquiry. For purposes of filing the report, “diligent inquiry” means conducting a search and thorough review of relevant documents which are reasonably likely to contain significant information with regards to Internal control over financial reporting and making reasonable inquiries of current employees and agents whose duties include responsibility for Internal control over financial reporting.
Section 16D(5): The report must disclose any unremediated material weaknesses in Internal control over financial reporting that exist as of the balance sheet date. If the insurer or Group of insurers has identified an unremediated material weakness, management is not permitted to conclude that its Internal control over financial reporting is effective and it must include a description of the nature of any unremediated material weakness in the report. December 31 is used as the measurement date to whether a material control weakness is unremediated for purposes of reporting under this section of the Model.

Section 16D(6): Users of the report should be aware of the inherent limitations in Internal control over financial reporting. PCAOB Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting That is Integrated With an Audit of Financial Statements provides the following description of such inherent limitations:

Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Additionally, readers of the report should be aware that projecting management’s assertion regarding the effectiveness of Internal control over financial reporting to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate.

Section 16D(7): The report must include signatures of the chief executive officer and chief financial officer (or the equivalent position/title). If a report is being filed on behalf of a Group of insurers, management should identify the officeholders (i.e., the CEO and CFO of Company ABC) that have the authority to sign the report on behalf of all of the legal entities being reported upon within the Group of insurers.

Basis for Management’s Review and Assertions (Section 16E)

One of the primary reasons for the new Section 16 of the Model is to bring additional focus and attention to internal control over financial reporting. Financial reporting is the underpinning of many of the solvency oversight activities of insurance regulators. Section 16 of the Model identifies management’s responsibilities for internal control over financial reporting and provides regulators additional assurances of the effectiveness of internal control practices in a cost effective manner.

The basis for Management's Report of Internal Control over Financial Reporting shall be subject to insurance departments' financial condition examinations. Because of this and other solvency tools available to regulators, there is no requirement that the independent certified public accountant be engaged to perform an examination of the effectiveness of internal control over financial reporting. However, Section 9 requires the independent public accountant to consider (as that term is defined in AICPA Statement on Auditing Standards (SAS) No. 102, Defining Professional Requirements in Statements on Auditing Standards, or its replacement) the most recently available Management’s Report of Internal Control over Financial Reporting in planning and performing the audit of the statutory financial statements. SAS No. 102, paragraph 4 states, "If a SAS provides that a procedure or action is one that the auditor "should consider," the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not." AU Section 319 of the Professional Standards of the AICPA, Consideration of Internal Control in a Financial Statement Audit, requires that the auditor obtain an understanding of internal control sufficient to plan and execute the audit. It is in this

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context that the auditor is required to "consider" management's report. There is no requirement that the auditor test or otherwise use management's report.

The Model does not mandate a specific framework for management’s review and evaluation of internal controls. SEC registrants typically (but are not required to) use the COSO Internal Control-Integrated Framework in assessing the effectiveness of internal control over financial reporting. The COSO-sponsored “Enterprise Risk Management-Integrated Framework” and the PCAOB Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting are other examples of relevant literature companies may want to consider in applying such a framework. Under the Model, however, management, when making its assessment and preparing its report, has discretion as to the nature of the internal control framework used. Insurers shall have flexibility as to the frequency and scope of testing activities and the documentation provided upon examination to support the assertions. Management should assess and select an appropriate framework or approach based upon its business risks and objectives.

Management’s assertions about the effectiveness of internal controls enhance oversight and understanding of insurer solvency by allowing regulators to have greater confidence in the accuracy of financial reporting, which also provides a benefit to policyholders and creditors. An expected benefit of this enhancement, where internal controls are effective, is that financial examinations will become more efficient and risk-focused.

Management’s Report of Internal Control over Financial Reporting may span more than one legal entity. Because internal controls are primarily about processes and these processes are often applied across multiple legal entities within an organization, (e.g., investment systems, premium and loss/benefit systems, and financial reporting processes), management may consider common processes and the associated controls when determining the Group of insurers for reporting purposes.

The Model provides flexibility in meeting the requirements of Section 16D and E. The controls included in the scope of management’s report should only include those controls deemed significant or critical by management. The following examples represent aspects and components of internal control that insurers may want to consider when making the assertions and determining relevant documentary evidence. These are not intended to serve as, and should not be considered, requirements:

- The internal control environment including oversight provided by the Audit committee of the Board of Directors. Insurers may want to consider how they can demonstrate “Tone at the Top.” The insurer’s compliance programs, code of conduct and the processes for reporting policy exceptions and overrides of controls may also be appropriate to consider.

- The risk assessment process utilized and identification of the areas of potential material internal control risk related to the financial statement. Risk areas that one might typically find for an insurance enterprise include:
  - Investments (including capital expenditures)
  - Policy and Claim Reserves
  - Benefit Payments
  - Premiums / Agent’s Balances
  - Reinsurance
  - Related Party (Affiliate) Transactions
  - Operating Expenses/Taxes

- The control activities in place including procedures over financial reporting, which in management’s judgment are appropriate under the circumstances. These might include the daily or monthly controls management relies upon in the normal course of its activities. They would also
Implementation Guide

Appendix G

include any SAS 70 reports received from vendors upon which management relies. General information systems and technology controls might also be considered.

- The monitoring and testing processes used in the normal course of business to ascertain that the internal controls are in place and are working as intended. Insurers may want to consider describing the purpose, function or role of an internal audit department and/or describe other self-audit and analysis activities.

- The information and communication processes, including the frequency of reporting and monitoring activities and communication of internal control responsibilities.

Section 16D(5) of the Model indicates that if one or more unremediated material weaknesses in Internal control over financial reporting exists as of the balance sheet date, then management is not permitted to conclude that internal control over financial reporting is effective and it must include a description of the nature of any unremediated material weaknesses in the report. For purposes of this determination, material weakness has the same meaning as used in PCAOB or AICPA auditing literature – PCAOB Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting That is Integrated With an Audit of Financial Statements or AICPA AU Section 325, Communicating Internal Control Related Matters Identified in an Audit. Such guidance provides the following definitions:

Significant Deficiency – A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Material Weakness – A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

Insurers filing Management’s Report of Internal Control over Financial Reporting as a Group of insurers may want to also consider identifying or documenting common systems and controls used by multiple companies within an insurance holding company system and how such information was used in the development of the Group of insurers for reporting purposes.

To allow insurers to comply with Section 16 in a cost effective manner, management may base its assertions, in part, upon its review, monitoring and testing processes performed in the normal course of it activities. Management may also consider diligent inquiry of key process owners throughout the organization to provide additional assurance as to the operating effectiveness of its internal control over financial reporting. For purposes of filing the report, “diligent inquiry” means conducting a search and thorough review of relevant documents which are reasonably likely to contain significant information with regards to Internal control over financial reporting and making reasonable inquiries of current employees and agents whose duties include responsibility for Internal control over financial reporting.

Exemptions and Effective Dates (Section 17)

Hardship Waivers (Section 17A)

Notwithstanding any other provision of the Model, an insurer may make written application to the Commissioner for waiver from any or all provisions of the Model based upon financial or organizational hardship. For example, the Commissioner could under this section grant a waiver of the Section 14B audit committee independence requirements to a company exceeding the $500 million premium threshold, even though the Section 14H waiver would not apply. This exemption is granted at the discretion of the Commissioner, and may be granted at any time for a specified period or periods.
Specific Effective Dates (Section 17F)

An insurer will be required to file a Section 16 report if the insurer exceeds the premium threshold (as defined in Section 16A.)

1. Assume the insurer reports premiums as follows (note that the direct written and assumed premium in these examples would be reduced by any premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program):

<table>
<thead>
<tr>
<th>$ millions</th>
<th>201x</th>
<th>201x+1</th>
<th>201x+2</th>
<th>201x+3</th>
<th>201x+4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net (written) premiums, per Statement of Operations in Audited financial report</td>
<td>350.3</td>
<td>390.8</td>
<td>410.5</td>
<td>425.7</td>
<td>450.8</td>
</tr>
<tr>
<td>Add: Reinsurance ceded</td>
<td>100.5</td>
<td>115.7</td>
<td>115.8</td>
<td>120.1</td>
<td>127.2</td>
</tr>
<tr>
<td>Gross direct written and assumed premium</td>
<td>450.8</td>
<td>506.5</td>
<td>526.3</td>
<td>545.8</td>
<td>578.0</td>
</tr>
</tbody>
</table>

In the above example, the insurer has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3.

2. Assume the insurer reports premiums as follows:

<table>
<thead>
<tr>
<th>$ millions</th>
<th>201x</th>
<th>201x+1</th>
<th>201x+2</th>
<th>201x+3</th>
<th>201x+4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net (written) premiums, per Statement of Operations in Audited financial report</td>
<td>350.3</td>
<td>380.5</td>
<td>390.8</td>
<td>410.5</td>
<td>425.7</td>
</tr>
<tr>
<td>Add: Reinsurance ceded</td>
<td>100.5</td>
<td>110.7</td>
<td>115.7</td>
<td>115.8</td>
<td>120.1</td>
</tr>
<tr>
<td>Gross direct written and assumed premium</td>
<td>450.8</td>
<td>491.2</td>
<td>506.5</td>
<td>526.3</td>
<td>545.8</td>
</tr>
</tbody>
</table>

In the above example, the insurer has reached the requisite threshold in 201x+2 and therefore will file its first Section 16 report effective December 31, 201x+4.

3. Assume the insurer reports premiums as follows:

<table>
<thead>
<tr>
<th>$ millions</th>
<th>201x</th>
<th>201x+1</th>
<th>201x+2</th>
<th>201x+3</th>
<th>201x+4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net (written) premiums, per Statement of Operations in Audited financial report</td>
<td>350.3</td>
<td>390.8</td>
<td>380.5</td>
<td>410.5</td>
<td>425.7</td>
</tr>
<tr>
<td>Add: Reinsurance ceded</td>
<td>100.5</td>
<td>115.7</td>
<td>110.7</td>
<td>115.8</td>
<td>120.1</td>
</tr>
<tr>
<td>Gross direct written and assumed premium</td>
<td>450.8</td>
<td>506.5</td>
<td>491.2</td>
<td>526.3</td>
<td>545.8</td>
</tr>
</tbody>
</table>

In the above example, the insurer has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3. Because the insurer dropped below the threshold in 201x+2, the insurer is not required to file a Section 16 report and thus, the reporting period starts over. The insurer reaches the threshold in 201x+3 and therefore, required to file the Section 16 report effective December 31, 201x+5. The insurer may choose to begin voluntarily filing the Section 16 report beginning with 201x+3 especially if the insurer has done the work to prepare the report.

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Business Combination

A business combination is defined as acquisition of insurance/reinsurance business through:
   A. a stock acquisition,
   B. inforce reinsurance assumption, or
   C. a merger of insurers in a Group of insurers

A. Stock Acquisitions

Assume Company A, which has premiums of $500m or more, buys Company B and retains Company B as a separate legal entity.

If Company B has premiums of less than $500m (as derived from Section 16A), no Section 16 report is required.

If Company B has premiums of $500m or more (as derived from Section 16A), a Section 16 report is required.

1. Assume Company B is acquired effective January 1, 201x and subsequently reports premiums as follows. Assume further that Company A and B elect to file separate Section 16 reports:

   \[
   \begin{array}{lcccc}
   \text{\$ millions} & 201x & 201x+1 & 201x+2 & 201x+3 \\
   \hline
   \text{Net (written) premiums, per Statement of Operations in Audited financial report} & 350.3 & 390.8 & 410.5 & 425.7 \\
   \text{Add: Reinsurance ceded} & 100.5 & 115.7 & 115.8 & 120.1 \\
   \text{Gross direct written and assumed premium} & 450.8 & 506.5 & 526.3 & 545.8 \\
   \end{array}
   \]

   In the above example, Company B has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3.

2. Assume Company B is acquired June 30, 201x+2 by Company A and Company B has premiums as follows. Assume further that Company A elects to file a single Section 16 report with the Group of insurers consisting of Company A and B:

   \[
   \begin{array}{lcccc}
   \text{\$ millions} & 201x & 201x+1 & 201x+2 & 201x+3 \\
   \hline
   \text{Net (written) premiums, per Statement of Operations in Audited financial report} & 350.3 & 390.8 & 410.5 & 425.7 \\
   \text{Add: Reinsurance ceded} & 100.5 & 115.7 & 115.8 & 120.1 \\
   \text{Gross direct written and assumed premium} & 450.8 & 506.5 & 526.3 & 545.8 \\
   \end{array}
   \]

   In the above example, Company B has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3. However due to the acquisition in 201x+2, the first combined Section 16 report, i.e., Group of insurers, would be effective December 31, 201x+4, two years subsequent to acquisition.
B. Inforce reinsurance assumption

For the purposes of determining premiums pursuant to Section 16A, assumed premiums from the assumption of an inforce reinsurance transaction will be excluded from the measurement of premiums, for two calendar years subsequent to acquisition.

Assume the insurer assumed an inforce transaction effective June 30, 201x+2 and reports premiums as follows:

<table>
<thead>
<tr>
<th>$ millions</th>
<th>201x</th>
<th>201x+1</th>
<th>201x+2</th>
<th>201x+3</th>
<th>201x+4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net (written) premiums, per Statement of Operations in Audited financial report</td>
<td>350.3</td>
<td>390.8</td>
<td>610.5</td>
<td>850.7</td>
<td>875.8</td>
</tr>
<tr>
<td>Add: Reinsurance ceded</td>
<td>100.5</td>
<td>115.7</td>
<td>115.8</td>
<td>120.1</td>
<td>127.2</td>
</tr>
<tr>
<td>Gross direct written and assumed premium</td>
<td>450.8</td>
<td>506.5</td>
<td>726.3</td>
<td>970.8</td>
<td>1,003.0</td>
</tr>
<tr>
<td>Less: Gross assumed premium resulting from a business combination</td>
<td>0</td>
<td>0</td>
<td>200.0</td>
<td>425.0</td>
<td>425.0</td>
</tr>
<tr>
<td>Gross direct written and assumed premium, subject to Section 16</td>
<td>450.8</td>
<td>506.5</td>
<td>526.3</td>
<td>545.8</td>
<td>578.0</td>
</tr>
</tbody>
</table>

In the above example, the insurer has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3, however only for business inforce in 201x+1 and still inforce in 201x+3. The business assumed at June 30, 201x+2 will be subject to a Section 16 report effective December 31, 201x+4, two calendar years after acquisition.

C. Mergers of Insurers in a Group of insurers

If the merged insurer has premiums of less than $500m (as derived from Section 16A), a Section 16 report is not required.

If the merged insurer has premiums of $500m or more (as derived from Section 16A), a Section 16 report is required.

1. Assume that Insurer A and Insurer B have Gross direct written and assumed premiums as follows, and agree to merge effective January 1, 201x+1, with Insurer A as the surviving entity:

<table>
<thead>
<tr>
<th>$ millions</th>
<th>201x</th>
<th>201x+1</th>
<th>201x+2</th>
<th>201x+3</th>
<th>201x+4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross direct written and assumed premium – Insurer A</td>
<td>450.3</td>
<td>460.8</td>
<td>510.5</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Gross direct written and assumed premium – Insurer B</td>
<td>100.5</td>
<td>115.7</td>
<td>115.8</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Less: Intercompany transactions – gross</td>
<td>n/a</td>
<td>65.3</td>
<td>62.2</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Combined gross direct written and assumed premiums Insurer A</td>
<td>n/a</td>
<td>511.2</td>
<td>564.1</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

In the above example, the merged entity (insurer A) has reached the requisite threshold in 201x+1, and will file its first Section 16 report effective December 31, 201x+3.
2. Assume that Insurer A and Insurer B have Gross direct written and assumed premiums as follows, and agree to merge effective January 1, 201x+2, with Insurer A as the surviving entity:

<table>
<thead>
<tr>
<th>$ millions</th>
<th>201x</th>
<th>201x+1</th>
<th>201x+2</th>
<th>201x+3</th>
<th>201x+4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross direct written and assumed premium – Insurer A</td>
<td>450.3</td>
<td>460.8</td>
<td>510.5</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Gross direct written and assumed premium – Insurer B</td>
<td>100.5</td>
<td>115.7</td>
<td>115.8</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Less: Intercompany transactions – gross</td>
<td>-</td>
<td>-</td>
<td>62.2</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Combined gross direct written and assumed premiums Insurer A</td>
<td>-</td>
<td>-</td>
<td>564.1</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

In the above example, the merged entity (insurer A) has reached the requisite threshold in 201x+2, and will file its first Section 16 report effective December 31, 201x+4, two years subsequent to merger.
APPENDIX 1

Illustrative Examples of Management’s Report of Internal Control over Financial Reporting

The following are examples of Management’s Report of Internal Controls over Financial Reporting utilizing different facts and circumstances. These are only examples and individual company facts and circumstances will dictate the contents of their report. However, there are common elements that should be included in all reports as discussed in Sections 16C and 16D of the Model.

Example A: An SEC registrant or a member of a holding company system whose parent is an SEC registrant that had all material control processes over statutory financial reporting addressed in its Section 404 report........................................................................................................Page 23

Example B: An SEC registrant or a member of a holding company system who is a SEC registrant and is a non-accelerated filer that had all material control processes over statutory financial reporting addressed in its Section 404 report. For these non-accelerated filers, the Section 404 report does not require the report of independent registered public accounting firm on internal control over financial reporting..............................................................Page 25

Example C: An SEC registrant or a member of a holding company system whose parent is an SEC registrant that did not have all material control processes over statutory financial reporting addressed in its Section 404 report .....................................................................................Page 27

Example D: An SEC registrant or a member of a holding company system who is a SEC registrant and did not have all material control processes over statutory financial reporting addressed in its Section 404 report. For these non-accelerated filers, the Section 404 report does not require the report of independent registered public accounting firm on internal control over financial reporting..............................................................Page 30

Example E: A non-SEC registrant that voluntarily complied with Section 404 of the Sarbanes-Oxley Act and produced a report on internal controls which included an auditor’s opinion........................................................................................................................................Page 33

Example F: A company that is not subject to Section 404 and utilized their own framework to evaluate controls........................................................................................................................................Page 35

Example G: An SEC registrant or a member of a holding company system whose parent is an SEC registrant that had all material control processes addressed in their Section 404 report and had an unremediated material weakness ........................................................................................................Page 36

Example H: An SEC registrant or member of a holding company system whose parent is an SEC registrant that did not include all material processes over statutory financial reporting addressed in its Section 404 report and had an unremediated material weakness noted ............... Page 38

Example I: An SEC registrant or member of a holding company system whose parent is an SEC registrant that had all material processes over statutory financial reporting addressed in its Section 404 report. However, they recently acquired another insurer that is not included in their assessment........................................................................................................................................Page 41
EXAMPLE A: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT HAD ALL MATERIAL CONTROL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT

Management’s Report of Internal Control over Financial Reporting

XYZ Holding Company Inc (“XYZ”) is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ’s Management’s Report of Internal Control over Financial Reporting, management has identified its “Group of insurers,” as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers’ internal control over statutory financial reporting, based on the framework established in *Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*. Based on our assessment under that framework, management concluded that the Group of insurers’ internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers’ obligation to deliver Management’s Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ’s Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers’ internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed) ____________________________ (Date) ____________
(Chief Executive Officer)

(Signed) ____________________________ (Date) ____________
(Chief Financial Officer)
ATTACHMENT A

XYZ Holding Company Inc
Addendum to Management’s Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this addendum, the “Section 404 Report” means Management’s Report on Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Form 10-K/20-F. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company Inc.
Management’s Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

<table>
<thead>
<tr>
<th>Name</th>
<th>NAIC No</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Insurance Subsidiary</td>
<td>12345</td>
</tr>
<tr>
<td>DEF Insurance Subsidiary</td>
<td>12346</td>
</tr>
<tr>
<td>GHI Insurance Subsidiary</td>
<td>12347</td>
</tr>
<tr>
<td>JKL Insurance Subsidiary</td>
<td>12348</td>
</tr>
<tr>
<td>MNO Insurance Subsidiary</td>
<td>12349</td>
</tr>
</tbody>
</table>
EXAMPLE B: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHO IS A SEC REGISTRANT AND IS A NON-ACCELERATED FILER THAT HAD ALL MATERIAL CONTROL PROCESSES OVER STATUTORY REPORTING ADDRESSED IN ITS SECTION 404 REPORT. FOR THIS NON-ACCELERATED FILER, THE SECTION 404 REPORT DOES NOT REQUIRE THE REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING.

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company Inc ("XYZ") is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model] as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers’ internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment under that framework, management concluded that the Group of insurers’ internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers’ obligation to deliver Management’s Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16 of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management’s Report of Internal Control over Financial Reporting included in XYZ’s Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). This does not include a report of independent registered public accounting firm on internal control over financial reporting for XYZ, as it is not required for non-accelerated filers. In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers’ internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____________________________________________ (Date)______________
(Chief Executive Officer)

(Signed)____________________________________________ (Date)______________
(Chief Financial Officer)
ATTACHMENT A

XYZ Holding Company Inc
Addendum to Management’s Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this filing, the “Section 404 Report” means Management’s Report of Internal Control over Financial Reporting only contained in or incorporated by reference in the Company’s Form 10-K/20-F. This does not include a report of independent registered public accounting firm on internal control over financial reporting, as it is not required for non-accelerated filers. Accordingly, as required by [relevant state statute or Section 16 of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company Inc.
Management’s Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

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EXAMPLE C: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT DID NOT HAVE ALL MATERIAL CONTROL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT

Management’s Report of Internal Control over Financial Reporting

XYZ Holding Company Inc (“XYZ”) is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ’s Management’s Report of Internal Control over Financial Reporting, management has identified its “Group of insurers,” as that term is defined in [relevant state statute or Section 3H of the Model] as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers’ internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment under that framework, management concluded that the Group of insurers’ internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers’ obligation to deliver Management’s Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ’s Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers’ internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)__________________________________________ (Date)______________
(Chief Executive Officer)

(Signed)__________________________________________ (Date)______________
(Chief Financial Officer)
ATTACHMENT A

XYZ Holding Company Inc
Addendum to Management’s Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this filing, the “Section 404 Report” means Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Company’s Form 10-K/20-F. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that the only material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report are the processes discussed below. Management of XYZ hereby affirms that all other material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers were included in the Section 404 Report. The following statutory financial reporting processes were reviewed separately from the internal controls reported by the Group of insurers in its Section 404 report:

Significant Control Processes not tested due to Group Materiality Considerations

The Section 404 report excludes certain control processes deemed material to individual insurance legal entities included within the Group of insurers. This exclusion was due to group materiality decisions made at the parent company level. These processes, and the legal entities within the Group of insurers impacted, are listed as follows:

Workers’ Compensation Claims Processing – The HIJ claims processing system is utilized to process workers’ compensation claims material to ABC Insurance Subsidiary and DEF Insurance Subsidiary.

Related Party Transactions Eliminated through Consolidation

The Section 404 report does not consider controls surrounding related party transactions as the effects of those transactions are eliminated through consolidation at the holding company financial statement level. Significant related party transactions, and the legal entities within the Group of insurers impacted, are listed as follows:

Affiliate reinsurance agreements – A significant amount of reinsurance coverage is obtained by ABC Insurance Subsidiary and DEF Insurance Subsidiary through contracts with XYZ Parent Company.

Management service agreements – ABC Insurance Subsidiary receives all of its management services through an agreement with XYZ Parent Company.

Tax allocation agreements – ABC Insurance Subsidiary and DEF Insurance Subsidiary are subject to an intercompany tax allocation agreement with XYZ Parent Company.

Deferred Income Taxes

Federal income taxes are provided for XYZ’s estimated current and deferred liability. Deferred taxes are provided for differences between the financial statement and tax bases of assets and liabilities. Pursuant to SSAP No. 10, Income Taxes, changes in deferred tax assets and liabilities are recognized as a separate component of gains and losses in statutory surplus, while under GAAP/IFRS, these changes are included in income tax expense or benefit. Gross deferred tax assets not meeting the realization criteria outlined in SSAP 10 are not admitted.
Nonadmitted Assets

Certain XYZ assets (principally furniture, equipment, prepaid expenses, agents’ balances, and certain deferred tax assets) have been designated as nonadmitted assets under statutory accounting guidance (primarily in SSAP No. 4, Assets and Nonadmitted Assets and SSAP No. 20, Nonadmitted Assets). Such nonadmitted assets are excluded from assets by a charge to statutory surplus. Under GAAP/IFRS, such amounts are carried at amortized cost with an appropriate valuation allowance, as necessary.

Asset Valuation Reserve (“AVR”)

The AVR represents a statutory contingency reserve for life and health insurers for credit related risk on most invested assets, and is charged to surplus pursuant to SSAP No. 7, Asset Valuation Reserve and Interest Maintenance Reserve. No such reserve is required under GAAP/IFRS accounting.

Interest Maintenance Reserve (“IMR”)

The IMR represents the deferral of interest-related realized gains and losses, net of tax, on primarily fixed maturity investments, amortized into income over the remaining life of the investment sold pursuant to SSAP No. 7, Asset Valuation Reserve and Interest Maintenance Reserve. No such reserve is required under GAAP/IFRS accounting.

Management of XYZ conducted an assessment of the internal controls over these processes and concluded that they were effective with respect to the audited statutory financial statements.

(Please note that this is not intended to be an all-inclusive list. It should only include material process that were not covered in the Section 404 Report. The facts and circumstances of each situation will determine the items to be included.)

ATTACHMENT B

XYZ Holding Company Inc.
Management’s Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

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EXAMPLE D: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHO IS A SEC REGISTRANT AND IS A NON-ACCELERATED FILER THAT DID NOT HAVE ALL MATERIAL CONTROL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT. FOR THESE NON-ACCELERATED FILERS, THE SECTION 404 REPORT DOES NOT REQUIRE THE REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING.

Management’s Report of Internal Control over Financial Reporting

XYZ Holding Company Inc (“XYZ”) is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ’s Management’s Report of Internal Control over Financial Reporting, management has identified its “Group of insurers,” as that term is defined in [relevant state statute or Section 3H of the Model] as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers’ internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment under that framework, management concluded that the Group of insurers’ internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers’ obligation to deliver Management’s Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16 of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management’s Report of Internal Control over Financial Reporting included in XYZ’s Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). This does not include a report of independent registered public accounting firm on internal control over financial reporting for XYZ, as it is not required for non-accelerated filers. In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers’ internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____________________________________________ (Date)______________
(Chief Executive Officer)

(Signed)____________________________________________ (Date)______________
(Chief Financial Officer)
ATTACHMENT A

XYZ Holding Company Inc
Addendum to Management’s Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this filing, the “Section 404 Report” means Management’s Report of Internal Control over Financial Reporting only contained in or incorporated by reference in the Company’s Form 10-K/20-F. This does not include a report of independent registered public accounting firm on internal control over financial reporting, as it is not required for non-accelerated filers. Accordingly, as required by [relevant state statute or Section 16 of the Model], management of XYZ hereby affirms that the only material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report are the processes discussed below. Management of XYZ hereby affirms that all other material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers were included in the Section 404 Report.

**Significant Control Processes not tested due to Group Materiality Considerations**

The Section 404 report excludes certain control processes deemed material to individual insurance legal entities included within the Group of insurers. This exclusion was due to group materiality decisions made at the parent company level. These processes, and the legal entities within the Group of insurers impacted, are listed as follows:

Workers’ Compensation Claims Processing – The HIJ claims processing system is utilized to process workers’ compensation claims material to ABC Insurance Subsidiary and DEF Insurance Subsidiary.

**Related Party Transactions Eliminated through Consolidation**

The Section 404 report does not consider controls surrounding related party transactions as the effects of those transactions are eliminated through consolidation at the holding company financial statement level. Significant related party transactions, and the legal entities within the Group of insurers impacted, are listed as follows:

Affiliate reinsurance agreements – A significant amount of reinsurance coverage is obtained by ABC Insurance Subsidiary and DEF Insurance Subsidiary through contracts with XYZ Parent Company.

Management service agreements – ABC Insurance Subsidiary receives all of its management services through an agreement with XYZ Parent Company.

Tax allocation agreements – ABC Insurance Subsidiary and DEF Insurance Subsidiary are subject to an intercompany tax allocation agreement with XYZ Parent Company.

**Deferred Income Taxes**

Federal income taxes are provided for XYZ’s estimated current and deferred liability. Deferred taxes are provided for differences between the financial statement and tax bases of assets and liabilities. Pursuant to SSAP No. 10, Income Taxes, changes in deferred tax assets and liabilities are recognized as a separate component of gains and losses in statutory surplus, while under GAAP/IFRS, these changes are included in income tax expense or benefit. Gross deferred tax assets not meeting the realization criteria outlined in SSAP 10 are not admitted.
Nonadmitted Assets

Certain XYZ assets (principally furniture, equipment, prepaid expenses, agents’ balances, and certain deferred tax assets) have been designated as nonadmitted assets under statutory accounting guidance (primarily in SSAP No. 4, Assets and Nonadmitted Assets and SSAP No. 20, Nonadmitted Assets). Such nonadmitted assets are excluded from assets by a charge to statutory surplus. Under GAAP/IFRS, such amounts are carried at amortized cost with an appropriate valuation allowance, as necessary.

Asset Valuation Reserve (“AVR”)

The AVR represents a statutory contingency reserve for life and health insurers for credit related risk on most invested assets, and is charged to surplus pursuant to SSAP No. 7, Asset Valuation Reserve and Interest Maintenance Reserve. No such reserve is required under GAAP/IFRS accounting.

Interest Maintenance Reserve (“IMR”)

The IMR represents the deferral of interest-related realized gains and losses, net of tax, on primarily fixed maturity investments, amortized into income over the remaining life of the investment sold pursuant to SSAP No. 7, Asset Valuation Reserve and Interest Maintenance Reserve. No such reserve is required under GAAP/IFRS accounting.

Management of XYZ conducted an assessment of the internal controls over these processes and concluded that they were effective with respect to the audited statutory financial statements.

(Please note that this is not intended to be an all-inclusive list. It should only include material process that were not covered in the Section 404 Report. The facts and circumstances of each situation will determine the items to be included.)

ATTACHMENT B

XYZ Holding Company Inc.
Management’s Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

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EXAMPLE E: A NON-SEC REGISTRANT THAT VOLUNTARILY COMPLIED WITH SECTION 404 OF THE SARBANES-OXLEY ACT AND PRODUCED A REPORT ON INTERNAL CONTROLS WHICH INCLUDED AN AUDITOR’S OPINION

Management’s Report of Internal Control over Financial Reporting

As a non-SEC registrant, XYZ Holding Company Inc (“XYZ”) is not required to prepare or file with the U.S. Securities and Exchange Commission a Sarbanes-Oxley Act Section 404 report on internal control over financial reporting. However, management has elected to prepare, and have audited by XYZ’s independent certified public accountant, such a report for the fiscal year-ended December 31, 201X.

Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ’s Management’s Report of Internal Control over Financial Reporting, management has identified its “Group of insurers,” as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers’ internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment under that framework, management concluded that the Group of insurers’ internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers’ obligation to deliver Management’s Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] the attached copy of XYZ’s Section 404 Report for the fiscal year ended December 31, 201X, which includes Management’s Report of Internal Control over Financial Reporting and report of independent registered public accounting firm on internal control over financial reporting for XYZ. In addition, an Addendum (Attachment A) is included to this report that identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers’ internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____________________________________________ (Date)______________
Chief Executive Officer

(Signed)____________________________________________ (Date)______________
Chief Financial Officer
ATTACHMENT A

XYZ Holding Company Inc
Addendum to Management’s Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this addendum, the “Section 404 Report” means Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Annual Report to Stockholders. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company Inc.
Management’s Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

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EXAMPLE F: A COMPANY THAT IS NOT SUBJECT TO SECTION 404 AND UTILIZED THEIR OWN FRAMEWORK TO EVALUATE CONTROLS

Management’s Report of Internal Control over Financial Reporting

Management of ABC Insurance Company is responsible for establishing and maintaining adequate internal control over statutory financial reporting. The Company has established an internal control system designed to provide reasonable assurance regarding the fair presentation of statutory financial reporting. The Company developed its own internal framework for evaluating the effectiveness of internal control over statutory financial reporting. The Company’s framework includes the identification and evaluation of the company’s internal control environment and areas of potential material internal control risk, documentation of existing internal controls, monitoring and testing of those key controls, documentation of remedial actions planned or taken, if any, and communication of the findings of the evaluation by the Company’s senior management to the Audit committee of the Board of Directors.

Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Company’s internal control over statutory financial reporting, which included identifying, reviewing, monitoring and testing significant internal controls over statutory financial reporting. Based on our assessment under the above described approach and through diligent inquiry, management has concluded that the Company’s internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Company’s internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed) _______________________________ (Date) ____________
(Chief Executive Officer)

(Signed) _______________________________ (Date) ____________
(Chief Financial Officer)
EXAMPLE G: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT HAD ALL MATERIAL CONTROL PROCESSES ADDRESSED IN THEIR SECTION 404 REPORT AND HAD AN UNREMEDiated MATERIAL WEAKNESS

Management’s Report of Internal Control over Financial Reporting

XYZ Holding Company Inc (“XYZ”) is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly-owned subsidiary of XYZ. For the purpose of XYZ’s Management’s Report of Internal Control over Financial Reporting, management has identified its “Group of insurers,” as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers’ internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

A material weakness was noted in XYZ’s internal control over financial reporting related to the calculation of insurance reserves. Due to the manner in which the data for homeowners policies are captured by the systems used in its Southeastern US regional office, changes in XYZ’s estimate of insurance reserves for certain policies are not reviewed by XYZ’s Actuarial Department prior to being recorded in the company’s accounting records.

A material weakness is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the company’s financial statements will not be prevented, or detected and corrected on a timely basis. In connection with the weakness noted above, XYZ’s management has taken remedial actions to change its procedures for coding policies issued in the states affected so that all homeowners policy data are included in the Actuarial Department review of estimate of insurance reserves. This change was effective on July 1, 20XX.

As a result of the unremediated material weakness described above, XYZ management has concluded that, as of December 31, 201X, XYZ’s internal control over statutory financial reporting was not effective.

In satisfaction of the Group of insurers’ obligation to deliver Management’s Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ’s Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).
(Signed)____________________________________________ (Date)______________
(Chief Executive Officer)

(Signed)____________________________________________ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company Inc
Addendum to Management’s Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this addendum, the “Section 404 Report” means Management’s Report of Internal
Control over Financial Reporting and the report of independent registered public accounting firm on
internal control over financial reporting contained in or incorporated by reference in the Form 10-K/20-F.
Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ
hereby affirms that there are no material processes with respect to the preparation of the audited statutory
financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company Inc.
Management’s Report of Internal Control over Financial Reporting
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EXAMPLE H: AN SEC REGISTRANT OR MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT DID NOT INCLUDE ALL MATERIAL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT AND HAD AN UNREMEDIATED MATERIAL WEAKNESS NOTED

Management’s Report of Internal Control over Financial Reporting

XYZ Holding Company Inc (“XYZ”) is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly-owned subsidiary of XYZ. For the purpose of XYZ’s Management’s Report of Internal Control over Financial Reporting, management has identified its “Group of insurers,” as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers’ internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness was noted in XYZ’s internal control over financial reporting related to the calculation of insurance reserves. Due to the manner in which the data for homeowners policies are captured by the systems used in its Southeastern US regional office, changes in XYZ’s estimate of insurance reserves for certain policies are not reviewed by XYZ’s Actuarial Department prior to being recorded in the company’s accounting records.

A material weakness is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the company’s financial statements will not be prevented, or detected and corrected on a timely basis. In connection with the assessment above, XYZ’s management identified a material weakness as of December 31, 201X in the controls over the calculation of insurance reserves.

As a result of the unremediated material weakness described above, XYZ management has concluded that, as of December 31, 201X, XYZ’s internal control over statutory financial reporting was not effective.

In satisfaction of the Group of insurers’ obligation to deliver Management’s Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ’s Form 10-K for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).
ATTACHMENT A

XYZ Holding Company Inc
Addendum to Management’s Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this filing, the “Section 404 Report” means Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Company’s Form 10-K/20-F. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that the only material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report are the processes discussed below. Management of XYZ hereby affirms that all other material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers were included in the Section 404 Report. The following statutory financial reporting processes were reviewed separately from the internal controls reported by the Group of insurers in its Section 404 report:

Significant Control Processes not tested due to Group Materiality Considerations

The Section 404 report excludes certain control processes deemed material to individual insurance legal entities included within the Group of insurers. This exclusion was due to group materiality decisions made at the parent company level. These processes, and the legal entities within the Group of insurers impacted, are listed as follows:

Workers’ Compensation Claims Processing – The HIJ claims processing system is utilized to process workers’ compensation claims material to ABC Insurance Subsidiary and DEF Insurance Subsidiary.

Related Party Transactions Eliminated through Consolidation

The Section 404 report does not consider controls surrounding related party transactions as the effects of those transactions are eliminated through consolidation at the holding company financial statement level. Significant related party transactions, and the legal entities within the Group of insurers impacted, are listed as follows:

Affiliate reinsurance agreements – A significant amount of reinsurance coverage is obtained by ABC Insurance Subsidiary and DEF Insurance Subsidiary through contracts with XYZ Parent Company.

Management service agreements – ABC Insurance Subsidiary receives all of its management services through an agreement with XYZ Parent Company.

Tax allocation agreements – ABC Insurance Subsidiary and DEF Insurance Subsidiary are subject to an intercompany tax allocation agreement with XYZ Parent Company.

Deferred Income Taxes

Federal income taxes are provided for XYZ’s estimated current and deferred liability. Deferred taxes are provided for differences between the financial statement and tax bases of assets and liabilities. Pursuant to
SSAP No. 10, Income Taxes, changes in deferred tax assets and liabilities are recognized as a separate component of gains and losses in statutory surplus, while under GAAP/IFRS, these changes are included in income tax expense or benefit. Gross deferred tax assets not meeting the realization criteria outlined in SSAP 10 are not admitted.

**Nonadmitted Assets**

Certain XYZ assets (principally furniture, equipment, prepaid expenses, agents’ balances, and certain deferred tax assets) have been designated as nonadmitted assets under statutory accounting guidance (primarily in SSAP No. 4, Assets and Nonadmitted Assets and SSAP No. 20, Nonadmitted Assets). Such nonadmitted assets are excluded from assets by a charge to statutory surplus. Under GAAP/IFRS, such amounts are carried at amortized cost with an appropriate valuation allowance, as necessary.

**Asset Valuation Reserve (“AVR”)**

The AVR represents a statutory contingency reserve for life and health insurers for credit related risk on most invested assets, and is charged to surplus pursuant to SSAP No. 7, Asset Valuation Reserve and Interest Maintenance Reserve. No such reserve is required under GAAP/IFRS accounting.

**Interest Maintenance Reserve (“IMR”)**

The IMR represents the deferral of interest-related realized gains and losses, net of tax, on primarily fixed maturity investments, amortized into income over the remaining life of the investment sold pursuant to SSAP No. 7, Asset Valuation Reserve and Interest Maintenance Reserve. No such reserve is required under GAAP/IFRS accounting.

Management of XYZ conducted an assessment of the internal controls over these processes and concluded that they were effective with respect to the audited statutory financial statements.

(Please note that this is not intended to be an all-inclusive list. It should only include material processes that were not covered in the Section 404 Report. The facts and circumstances of each situation will determine the items to be included.)

**ATTACHMENT B**

**XYZ Holding Company Inc.**  
Management’s Report of Internal Control over Financial Reporting  
List of Companies that are part of the Group of insurers  
Pursuant to [relevant state statute or Section 16 of the Model]

<table>
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<th>Name</th>
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© 1999-2011 National Association of Insurance Commissioners
EXAMPLE 1: AN SEC REGISTRANT OR MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT HAD ALL MATERIAL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT. HOWEVER, THEY RECENTLY ACQUIRED ANOTHER INSURER THAT IS NOT INCLUDED IN THEIR ASSESSMENT

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company Inc (“XYZ”) is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ’s Management’s Report of Internal Control over Financial Reporting, management has identified its “Group of insurers,” as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers’ internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). This assessment excluded an evaluation of internal controls over financial reporting for RST Insurance Company which was recently acquired. Based on our assessment under that framework, management concluded that the Group of insurers’ internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers’ obligation to deliver Management’s Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ’s Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers’ internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed) __________________________________________________________________ (Date) ____________
(Chief Executive Officer)

(Signed) __________________________________________________________________ (Date) ____________
(Chief Financial Officer)
ATTACHMENT A

XYZ Holding Company Inc.
Addendum to Management’s Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this addendum, the “Section 404 Report” means Management’s Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Form 10-K. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company Inc.
Management’s Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
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Appendix H
Superseded SSAPs and Nullified Interpretations

Introduction

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.

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Statement of Statutory Accounting Principles No. 8

Pensions

STATUS

Type of Issue: Common Area

Issued: Finalized March 13, 2000

Effective Date: January 1, 2001

Affects: No other pronouncements

Affected by: Superseded by SSAP No. 89

Interpreted by: INT 99-24, INT 99-26, INT 01-16, INT 01-17, INT 02-18, INT 03-18

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Pensions

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for employers’ pension obligations.

SUMMARY CONCLUSION

Defined Benefit Plans

2. 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 FASB Statement No. 87, Employers’ Accounting for Pensions (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 statement shall be considered a nonadmitted asset, as such an asset cannot be readily converted to cash to satisfy policyholder obligations.

3. If a reporting entity settles or curtails a defined benefit plan, the reporting entity shall immediately recognize all previously unrecognized amounts as discussed below.

4. 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. When such gains are recognized, any excise tax surcharges shall also be recognized.

5. 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 excise 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 following disclosures shall be made for defined benefit pension plans for which the reporting entity is directly liable:

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

b. The amount of the pension obligation for non-vested employees as of the most recent actuarial valuation date;

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

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

i. The amount of any unamortized prior service cost;

ii. The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value);

iii. The amount of any remaining unamortized, unrecognized net obligation or net asset existing at the initial date of application of this statement;

iv. The net pension or other postretirement benefit prepaid assets or accrued liabilities; and

v. Any intangible asset;

e. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized incremental liability or incremental asset (see paragraph 18), the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment;

f. The amount included in income for the period arising from a change in the additional minimum pension liability recognized pursuant to paragraph 37 of FAS 87;
g. 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;

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

i. If applicable, any alternative amortization method used to amortize prior service amounts or unrecognized net gains and losses pursuant to paragraphs 26 and 33 of FAS 87;

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

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

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

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

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

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

12. Refer to the preamble for further discussion regarding disclosure requirements.

**Consolidated/Holding Company Plans**

13. 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.

14. The reporting entity shall disclose in 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 in paragraphs 2 to 12 and 15 to 21 of this statement shall be applied.
Relevant Literature

15. The conclusions in paragraphs 2 to 12 and 16 to 21 adopt FAS 87, FASB Statement No. 88, Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits and FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits (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 excise 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 of this statement;

   f. The disclosures relating to the initial date of application in paragraph 5 of FAS 132 shall be the initial date of adoption of this statement; and

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

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

Effective Date and Transition

17. This statement is effective for years beginning January 1, 2001.

18. As of January 1, 2001, the transition obligation or asset shall be determined as the difference between the projected benefit obligation for vested employees and the fair value of plan assets. If prior to the effective date of January 1, 2001, the reporting entity has adopted FAS 87 for statutory accounting purposes, the transition obligation or asset calculated above shall be compared to those amounts previously recorded under FAS 87. The difference between these amounts represents an incremental asset or liability. If the reporting entity has not previously adopted FAS 87 for statutory accounting purposes, the entire transition asset or obligation represents the incremental asset or liability.

19. As of January 1, 2001, if the reporting entity calculates an incremental liability, this liability shall be recognized according to one of the two following methods:
a. The reporting entity may elect to record the entire incremental liability as a direct charge to surplus;

b. Alternatively, the reporting entity may elect to amortize the incremental liability as a component of net periodic pension cost over a period not to exceed 20 years.

20. As of January 1, 2001, if the reporting entity calculates an incremental asset, this asset shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental asset as a direct credit to surplus;

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

21. 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 reported as nonadmitted.

**AUTHORITATIVE LITERATURE**

**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’ Disclosure about Pensions and Other Postretirement Benefits*
- *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*
- *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*

**RELEVANT ISSUE PAPERS**

- *Issue Paper No. 8—Accounting for Pensions*
# Statement of Statutory Accounting Principles No. 18

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

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## SSAP NO. 18—GLOSSARY

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Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for accounting for transfers and servicing of financial assets and extinguishments of liabilities. This statement discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement.

2. Except as addressed in this statement and in other statements (including, but not limited to, SSAP No. 15—Debt and Holding Company Obligations (SSAP No. 15), SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties, SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities, SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities), SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities), SSAP No. 42—Sale of Premium Receivables (SSAP No. 42), SSAP No. 43—Loan-backed and Structured Securities, SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (SSAP No. 45), and SSAP No. 33—Securitization (SSAP No. 33)), transfers and servicing of financial assets and extinguishments of liabilities shall be accounted for in accordance with FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125).

SUMMARY CONCLUSION

3. Except as discussed in paragraph 35, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 12 and 13);

   b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraph 14), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 9 of SSAP No. 33 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 14), to pledge or exchange those interests; and

   c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 15-17) or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (see paragraph 18).

4. Upon completion of any transfer of financial assets, the transferor shall:

   a. Continue to carry in its balance sheet any retained interest in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (see SSAP No. 33), and retained undivided interests (see paragraph 20); and
b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (see paragraphs 19 and 20).

5. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 3), the transferor (seller) shall:
   
   a. Eliminate the transferred assets from the balance sheet;
   
   b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;
   
   c. Record in its balance sheet, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);
   
   d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 5 c.) and liabilities incurred in consideration as proceeds of the sale;
   
   e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and
   
   f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses in the statement of income.

6. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).

7. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements shall meet the definition of SSAP No. 45. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 37. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

8. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 3, or (b) is a sale of receivables with recourse (see paragraph 35); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 10).
 Recognition and Measurement of Servicing Assets and Liabilities

9. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.

Secured Borrowings and Collateral

10. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 8). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:

a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:

i. The debtor shall disclose the amount of such assets and the secured party’s right to sell or repledge such collateral;

ii. The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;

d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.
Extinguishments of Liabilities

11. A debtor shall derecognize a liability if, and only if, it has been extinguished (see SSAP No. 15). A liability has been extinguished if either of the following conditions is met:

   a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities; or

   b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Isolation Beyond the Reach of the Transferor and Its Creditors

12. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (see SSAP No. 33).

13. Many common financial transactions, for example, typical repurchase agreements (see SSAP No. 45) and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

14. Many transferor-imposed or other conditions on a transferee’s contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor’s right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor’s permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor’s competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor’s competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Agreements That Maintain Effective Control Over Transferred Assets

15. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

   a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (see paragraph 16);
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (see paragraph 17);

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and

d. The agreement is entered into concurrently with the transfer.

16. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

   a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

   b. Identical form and type so as to provide the same risks and rights;

   c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);

   d. Identical contractual interest rates;

   e. Similar assets as collateral; and

   f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

17. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

18. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor’s effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

**Assets Obtained and Liabilities Incurred as Proceeds**

19. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.
Retained Interests

20. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 19.

Fair Value

21. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

22. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm’s-length transaction.

23. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Values

24. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

b. The amount that would be recognized in accordance with SSAP No. 5—Liabilities, Contingencies and Impairments of Assets.
Securities Lending Transactions

25. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities, net of direct expenses, shall be recorded in investment income in the subcategory of investment income known as aggregate write-ins for miscellaneous income. Interest income on loaned securities that is unrelated to securities lending shall be reported in the annual statement categories and exhibits that are consistent with the income earned on similar investment categories, e.g., bonds. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor’s balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor’s balance sheet and a separate liability shall be established on the transferor’s balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:

   a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities.

   b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.

26. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer’s failure to deliver securities sold. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

27. Securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (see paragraphs 15-18). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities
loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the
transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral
provided in securities lending transactions that are accounted for as secured borrowings shall be reported
disclosed like other collateral, as set forth in paragraphs 10 and 25.

28. In some transactions, characterized as securities lending, all of the criteria in paragraph 3 are met.
During the term of such agreements, the transferor has surrendered control over the securities transferred
and the transferee has obtained control over those securities, with the ability to sell or transfer them at
will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase
commitment. Those transactions shall be accounted for:

a. By the transferor as a sale of the loaned securities, for proceeds consisting of the
collateral and a forward repurchase commitment. (If the collateral is a financial asset that
the holder is permitted to sell or repledge and the debtor does not have the right and
ability to redeem the collateral on short notice, e.g., by substituting other collateral or
terminating the contract, that financial asset is proceeds of the sale of the loaned
securities. To the extent that the collateral consists of letters of credit or other financial
instruments that the holder is not permitted to sell or pledge, a securities lending
transaction does not satisfy the sale criteria and is accounted for as a loan of securities by
the transferor to the transferee); and

b. By the transferee as a purchase of the borrowed securities in exchange for the collateral
and a forward resale commitment.

Loan Syndications

29. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is
common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication
under which several lenders share in lending to a single borrower, but each lender loans a specific amount
to the borrower and has the right to repayment from the borrower.

30. Each lender in the syndication shall account for the amounts it is owed by the borrower.
Repayments by the borrower may be made to a lead lender who then distributes the collections to the
other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and,
therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

31. Groups of banks or other entities also may jointly fund large borrowings through loan
participations in which a single lender makes a large loan to a borrower and subsequently transfers
undivided interests in the loan to other entities.

32. Transfers by the originating lender may take the legal form of either assignments or
participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender)
continues to service the loan. The transferee (participating entity) may or may not have the right to sell or
transfer its participation during the term of the loan, depending upon the terms of the participation
agreement.

33. If the loan participation agreement gives the transferee the right to pledge or exchange those
participations and the other criteria in paragraph 3 are met, the transfers to the transferee shall be
accounted for by the transferor as sales of financial assets. A transferor’s right of first refusal on a bona
fide offer from a third party, a requirement to obtain the transferor’s permission that shall not be
unreasonably withheld, or a prohibition on sale to the transferor’s competitor is a limitation on the
transferee’s rights but presumptively does not constrain a transferee from exercising its right to pledge or
exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

**Factoring Arrangements**

34. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 3 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

**Transfers of Receivables with Recourse**

35. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42.

**Disclosures**

36. A reporting entity shall disclose the following:

   a. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;

   b. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted; and

   c. For all servicing assets and servicing liabilities:

      i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and

      ii. The fair value of servicing liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

37. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 7, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

   a. A description of the reporting entity’s objectives regarding these transactions;

   b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;

   c. The number of transactions involved during the reporting period;

   d. The book value of securities sold;

   e. The cost of securities repurchased; and

   f. The realized gains/losses associated with the securities involved.
SSAP No. 18  Superseded SSAPs and Nullified Interpretations

38. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 37 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Relevant Literature

39. This statement adopts FAS 125 with modification to paragraphs 9, 10 a., 11 d., 13, 15—17, 35—41, and 68. Additionally, paragraphs 14, 59—60, 77—81, and 83 are rejected. The modifications to FAS 125 primarily relate to (a) the nonadmission of servicing rights assets, (b) the accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements, (c) the accounting for realized gains and losses for reporting entities required to maintain an IMR, (d) the accounting for financial assets subject to prepayment, (e) the accounting for assets pledged as collateral, (f) the accounting for leases in accordance with SSAP No. 22—Leases, and (g) the accounting for sales of receivables with recourse. Paragraphs 77-81 are rejected because they are not applicable to the insurance industry.

40. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues, FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB Emerging Issues Task Force No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments.

41. This statement rejects FASB Statement No. 127, Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125, an amendment of FASB Statement No. 125, FASB Emerging Issues Task Force No. 84-5, Sale of Marketable Securities with a Put Option, FASB Emerging Issues Task Force No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse, and FASB Emerging Issues Task Force No. 96-20, Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities.

Effective Date and Transition

42. This statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2001, and shall be applied prospectively.

43. For each servicing contract in existence before January 1, 2001, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

AUTHORITATIVE LITERATURE

Statutory Accounting

- Purposes and Procedures Manual of the NAIC Securities Valuation Office
Generally Accepted Accounting Principles

- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position
- FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement
- FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold
- FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues
- FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios
- FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement
- FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights
- FASB Emerging Issues Task Force No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments
SSAP NO. 18—GLOSSARY

Beneficial interests
Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, and residual interests.

Cleanup call
An option held by the servicer, which may be the transferor, to purchase transferred financial assets when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome.

Collateral
Personal or real property in which a security interest has been given.

Derecognize
Remove previously recognized assets or liabilities from the balance sheet.

Derivative financial instrument
A futures, forward, swap, or option contract, or other financial instrument with similar characteristics.

Financial asset
Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Financial liability
A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Proceeds
Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse
The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Securitization
The process by which financial assets are transformed into securities.
Security interest
A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller
A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

Servicing asset
A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing liability
A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer
The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee
An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor
An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided interest
Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non–pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unrestricted collateral
Securities received that may be sold or repledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.
**Statement of Statutory Accounting Principles No. 28**

**Nonmonetary Transactions**

**STATUS**

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Nonmonetary Transactions

SCOPE OF STATEMENT

1. This statement establishes general statutory accounting principles for nonmonetary transactions. Specific statutory requirements for certain types of nonmonetary transactions are addressed in other statements.

SUMMARY CONCLUSION

2. The definitions of certain terms used in this statement are:

   a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash; amounts due from agents, brokers, and intermediaries; policy loans; accounts payable; and other amounts receivable or payable in cash;

   b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are common stocks; furniture, fixtures, and equipment; real estate and liabilities for rent collected in advance;

   c. Exchange (or exchange transaction) is a reciprocal transfer between a reporting entity and another entity that results in the reporting entity acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations;

   d. Nonreciprocal transfer is a transfer of assets or services in one direction, either from a reporting entity to its owners (whether or not in exchange for their ownership interests) or another entity, or from owners or another entity, to the reporting entity. An insurance company's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

3. Except as addressed in other statements (including, but not limited to, SSAP No. 12—Employee Stock Ownership Plans, SSAP No. 13—Stock Option and Stock Purchase Plans, SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25), SSAP No. 68—Business Combinations and Goodwill, and SSAP No. 72—Surplus and Quasi-reorganizations), nonmonetary transactions shall be accounted for in accordance with Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions (APB 29). The accounting for such transactions shall be based on the fair values of the assets (or services) involved, as defined in paragraph 25 of APB 29.

4. In a reciprocal transfer, the fair value of the asset surrendered shall be used to measure the cost of the assets received unless the fair value of the asset received is more clearly evident.

5. A nonmonetary asset received in a nonreciprocal transfer shall be recorded at the fair value of the asset received. A nonmonetary asset transferred to a stockholder or other entity in a nonreciprocal transfer shall be accounted for at the fair value of the asset transferred and a gain or loss on disposition of the asset recognized for the difference, if any, between fair value and carrying value of the asset transferred.

6. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities, SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities), SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities), SSAP No. 37—Mortgage Loans, SSAP No.
39—Reverse Mortgages, SSAP No. 40—Real Estate Investments, SSAP No. 43—Loan-Backed and Structured Securities or other applicable statement. The guidance provided in SSAP No. 25 shall be followed in accounting for nonreciprocal transactions.

7. Stock received in the form of a stock dividend or stock split shall not result in the recognition of income. The cost basis of stock held shall be reallocated ratably to the total shares held after receipt of the stock dividend or stock split.

8. Involuntary conversions of nonmonetary assets to monetary assets (for example, as a result of total or partial destruction, theft, seizure, or condemnation) are monetary transactions for which gain or loss shall be recognized even though a reporting entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with the conclusions in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5). Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be reported consistently with the reporting entity’s reporting of continuing operations and disclosed in the notes to financial statements in accordance with SSAP No. 24—Discontinued Operations and Extraordinary Items (SSAP No. 24).

Disclosures

9. A reporting entity that engages in a nonmonetary transaction during a period shall disclose the following in the financial statements:

   a. The nature of the transaction;
   
   b. The basis of accounting for the assets transferred; and
   
   c. Gains or losses recognized on transfers.

10. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure in paragraph 9 above shall be included in the annual audited statutory financial reports only.

Relevant Literature

11. This statement adopts APB 29, FASB Emerging Issues Task Force No. 86-29, Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value, and FASB Emerging Issues Task Force No. 93-11, Accounting for Barter Transactions Involving Barter Credits.

12. This statement adopts Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, “Chapter 7, Capital Accounts, Section B—Stock Dividends and Stock Split-ups,” paragraphs 1 through 9, as it relates to the receipt of stock in the form of a stock dividend or stock split.

13. This statement adopts FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets with modification to provide that gain or loss contingencies be recognized in accordance with SSAP No. 5, and that gain or loss resulting from an involuntary conversion of nonmonetary assets to monetary assets be accounted for in continuing operations and disclosed in accordance with SSAP No. 24.

14. This statement rejects paragraph 16 of Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins and Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners.
Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

- Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, “Chapter 7, Capital Stock, Section B—Stock Dividends and Stock Split-ups,” paragraphs 1 through 9
- FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets
- FASB Emerging Issues Task Force No. 86-29, Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value
- FASB Emerging Issues Task Force No. 93-11, Accounting for Barter Transactions Involving Barter Credits

RELEVANT ISSUE PAPERS

- Issue Paper No. 73—Nonmonetary Transactions
Statement of Statutory Accounting Principles No. 31

Derivative Instruments

STATUS

Type of Issue: Common Area
Issued: Initial Draft
Effective Date: January 1, 2001
Affects: No other pronouncements
Affected by: Superseded by SSAP No. 86
Interpreted by: No other pronouncements

STATUS

SCOPE OF STATEMENT

SUMMARY CONCLUSION

Hedge Accounting
Mark to Market Accounting
Consistent Application of Alternatives
Specific Accounting Procedures for Derivatives
Income Generation Transactions
Insurance Futures and Insurance Futures Options
Documentation Guidance
Disclosures
Relevant Literature
Effective Date and Transition

AUTHORITATIVE LITERATURE

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RELEVANT ISSUE PAPERS
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Derivative Instruments

SCOPE OF STATEMENT

1. The purpose of this statement is to establish statutory accounting principles for derivative instruments (hereinafter referred to as derivatives).

SUMMARY CONCLUSION

2. Derivatives are defined as swaps, options, forwards, futures, caps, floors, and collars. The following are general definitions for these derivative instruments.

Swaps

3. Swaps are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common.

4. An interest rate swap is a contractual agreement between two parties to exchange interest rate payments (usually fixed for variable) based on a specified amount of underlying assets or liabilities (known as the notional amount) for a specified period. The swap does not involve an exchange of principal. The result of these transactions is to transform payments from a variable rate to a fixed rate, from a fixed rate to a variable rate or from one variable rate index to another variable rate index.

5. Interest rate swaps have historically been entered into for the purpose of lowering borrowing costs, obtaining otherwise unavailable financing terms, and/or improving asset and liability management through a reduction of an entity’s exposure to interest rate risk. Banks and brokers will enter into an interest rate swap with an interested party before a swap partner is found, creating a swap portfolio. This activity allows the entity that desires a swap transaction immediate access to the market. This secondary market also allows a swap participant a vehicle to unwind or reverse swap positions it no longer wants or to receive cash if the position to be disposed of is favorable in relation to the current market.

6. While swaps may involve the trading of interest on liabilities or assets, the insurance industry has used swaps to match return on assets to contract obligations. Insurers also have acted as an intermediary or broker in the process of arranging a swap. Swaps may involve long periods of time and significant amounts of interest on substantial notional amounts. Unmatched or naked swaps are sometimes written where no underlying asset or liability exists.

7. The risk to the parties of a swap agreement is reduced by the fact that no transfer of principal is involved. The cash exchanged between the parties is usually the net interest differential only.

Options

8. Options are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter.
Forwards

9. Forward contracts are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument.

Futures

10. Futures are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies.

Caps

11. Caps are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate.

Floors

12. Floors are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount.

Collars

13. A collar is a combination of a cap and a floor (one purchased and one written). A collar fixes the rate between two levels (the strike prices of the cap and the floor).

14. To the extent a derivative is in an asset position, the instrument meets the definition of an asset as defined in SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) and is an admitted asset to the extent it conforms to the requirements of this statement. To the extent a derivative is in a liability position, the instrument meets the definition of a liability as defined in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5).
Hedge Accounting

General

15. A hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce:
   a. The risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities which the reporting entity has acquired or incurred or anticipates acquiring or incurring, or;
   b. The currency exchange rate risk or the degree of exposure as to assets or liabilities which a reporting entity has acquired or incurred or anticipates acquiring or incurring.

16. Derivatives used by reporting entities in hedging activities shall be accounted for in a manner consistent with the item hedged. For example, if the item being hedged is accounted for at amortized cost, the hedging derivative also is accounted for at amortized cost. If the item being hedged is accounted for at market value, the hedging derivative also is accounted for at market value.

Criteria to Qualify for Hedge Accounting

17. To qualify for hedge accounting, the derivative shall be designated as a hedge of a specific asset, liability, or anticipated transaction. The specific asset, liability, or anticipated transaction to be hedged must expose the reporting entity to a risk and the designated derivative transaction must reduce that exposure. Examples of items that expose the reporting entity to risk include change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities, or future cash flows which a reporting entity has acquired or incurred, or anticipates acquiring or incurring.

18. To satisfy the condition of risk reduction, the reporting entity shall demonstrate how the derivative reduces risk by using an appropriate method. There are a variety of methods available that can be used to demonstrate risk reduction, including methods which analyze the correlation of gains and losses on the derivative in relation to the losses and gains on the hedged asset, liability, or future cash flow.

19. Reporting entities shall set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and apply those criteria in the ongoing assessment of actual hedge results. For example, if correlation is used to measure the effectiveness of a hedge, high correlation of changes in the fair value of the derivative and the fair value of the item being hedged shall be probable so that such changes will substantially offset each other throughout the hedge period. Other methods used shall demonstrate a similar result to be considered effective. Also, at the inception of the hedge, formal documentation of the hedging instrument and the related hedged item, as provided in the documentation guidance section of this statement, shall be drafted and retained for future reference.

Gain or Loss Upon Termination

20. Upon termination of a derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the hedging derivative may be realized and shall be subject to IMR upon termination. Reporting entities shall account for a derivative at estimated fair value if it ceases to be effective as a hedge (that is, the gains and losses on the derivative no longer offset the losses and gains on the hedged instrument) and recognize the gain or loss currently in earnings.
Settlement Accounting for Swaps

21. Included in the concept of hedge accounting is the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue.

Mark to Market Accounting

22. Under the immediate recognition method of accounting, (i.e. mark to market) changes in fair value from one reporting period to another reporting period shall be recognized currently in earnings. The immediate recognition method of accounting (mark to market) shall be applied in situations where:

   a. A reporting entity enters into a derivative for other than hedging purposes;

   b. A portfolio has been hedged and the reporting entity is unable to assign the hedging instrument to specific assets and liabilities;

   c. There are derivatives that are not specifically addressed elsewhere in this guidance.

23. Other than hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. Unrealized gains and losses cannot be deferred when categorized as other than hedging.

24. Generally, mark to market accounting is used where it is impractical to allocate gains and losses to specific hedged assets, liabilities, or future cash flows. However, mark to market accounting is not precluded from being utilized in situations where the derivative qualifies for hedge accounting.

Consistent Application of Alternatives

25. The determination of hedge accounting or immediate recognition accounting shall be made for each individual instrument. A reporting entity may utilize immediate recognition accounting for certain derivatives within a category and hedge accounting for other derivatives within that same category. The reporting entity’s choice between hedge accounting and mark to market accounting shall be applied consistently for each individual instrument over the life of the derivative. A change in method shall be justified by a significant change in circumstance.

Specific Accounting Procedures for Derivatives

26. Call and Put Options, Caps, and Floors shall be accounted for as follows:

   a. Accounting at Date of Acquisition (purchase) or Issuance (written): The premium paid or received for purchasing or writing a call option, put option, cap or floor shall be recorded as an asset (purchase) or liability (written) as an Aggregate Write-in for Invested Asset (or) Liability;
b. Statement Value:

i. Open derivatives hedging items recorded at amortized cost:

(a) Options, caps, and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item;

(b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate securities, the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change). Specific treatment includes:

1. Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;

2. For anticipatory hedges, the derivative may be recorded at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;

3. For other derivatives, the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program.

(c) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The market value of the hedging and hedged items shall be determined and reported separately;

(d) If during the life of the derivative it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative shall be valued at its current market value (marked to market) with gains and losses recognized in earnings to the extent they ceased to be effective hedges.

ii. Open derivatives hedging items recorded at market value, (where gains and losses on the hedging item are recognized as adjustments to unassigned funds (surplus)):

(a) Options, caps, or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item;

(b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

(c) For hedges where the cost of the derivative is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative is zero.

iii. Open derivatives hedging items recorded at market value, where gains and losses on the hedging item are recognized currently in earnings and for open derivatives accounted for under the immediate recognition method, options, caps, or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently in earnings.
c. Cash Flows and Income

i. Where the cost of the derivative is not combined with the hedged item:

- Amortization of premium or discount on derivatives is an adjustment to net investment (operating) income;

- Periodic cash flows and accruals of income/expense shall be reported in a manner consistent with the hedged item, usually as other investment income (operating income).

ii. Where the cost of the derivative is combined with the hedged item, the cash flows and income of the derivative on Schedule DB will be zero. All related amortization and cash flow accounting shall be reported with the hedged item instead of with the derivative.

d. Gain/Loss on Termination of an option, cap or floor accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):

i. Exercise of an Option: The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;

ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate;

iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

27. Swaps, Collars, and Forwards shall be accounted for as follows:

a. Accounting at Date of Opening Position:

i. Any premium paid or received at date of opening shall be recorded as an asset (paid) or liability (received) as an Aggregate Write-in for Invested Asset (or) Liability;

b. Statement Value:

i. Open derivatives hedging items recorded at amortized cost:

- Swaps, collars, and forwards shall be valued at amortized cost in a manner consistent with hedged item;

- The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate securities the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:

  1. Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;
(2) For anticipatory hedges, the derivative may be recorded at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;

(3) For other derivatives the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program;

(4) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The market value of the hedging and hedged items shall be determined and reported separately;

(5) If during the life of the derivative it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative shall be valued at its current market value (marked to market) with gains and losses recognized in earnings to the extent that it ceased to be an effective hedge.

ii. Open derivatives hedging items recorded at market value (where gains and losses on the hedging item are recognized as adjustments to unassigned funds (surplus)):

(a) Swaps, collars, or forwards shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item;

(b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

(c) For hedges where the derivative is combined with the hedged item, the market value of the hedging and hedged items shall be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative is zero.

iii. Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars where the immediate recognition method of accounting is not being used:

(a) The foreign exchange premium (discount) on the currency contract shall be amortized into income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.

Amortization is not required if the contract was entered into within a year of maturity;

(b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as done to translate the hedged item;
| (c) | The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate; |
| (d) | The statement value of the currency contract equals the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract. The cumulative unrealized gain/(loss) equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened; |
| (e) | Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs; |
| (f) | For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value is zero. The market value of the hedging and hedged items is determined and reported separately; |
| (g) | If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost shall cease. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized in earnings equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge. |

iv. Open derivatives hedging items recorded at market value, where gains and losses on the hedging item are recognized currently in earnings and for open derivatives accounted for under the immediate recognition method, swaps, collars and forwards shall be valued at current market value (marked to market) with changes in market value recognized currently in earnings.

c. Cash Flows and Income:

i. Where the cost of the derivative is not combined with the hedged item:

(a) Amortization of premium or discount on derivatives is an adjustment to net investment (operating) income;

(b) Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income).

ii. Where the cost of the derivative is combined with the hedged item, the cash flows and income of the derivative on Schedule DB is zero. All related amortization and cash flow accounting shall be reported with the hedged item instead of with the derivative.

d. Gain/Loss on Termination of a swap, collar or forward accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):
i. Exercise—The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;

ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate;

iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges;

28. Futures shall be accounted for as follows:

a. Accounting at Date of Acquisition:

   i. Positions in futures contracts shall be initially valued at the amount of cash deposits (i.e., basis or book value of the contract), if any, placed with a broker. Subsequent additions (reductions) in cash deposits plus changes in contract value from date of contract opening (i.e., variation margin) paid (received) will increase (decrease) the book value of the futures contract.

b. Statement Value:

   i. Hedges of Items Recorded at Amortized Cost:

      (a) Futures shall be valued at book value;

      (b) Book value of open futures contracts need not be amortized;

      (c) For hedges where the cost of the futures contract is combined with the hedged item, the statement value would be equal to cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding;

      (d) If during the life of the futures contract it is no longer effective as a hedge, valuation at book value (deferral accounting) ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized in earnings to the extent it ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding.

ii. Hedges of Items Recorded at Market Value (where gains and losses on the hedging item are recognized as adjustments to unassigned funds (surplus)):

      (a) Changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently consistent with the hedged item. Statement value will be limited to the cash deposits outstanding;

      (b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

      (c) For hedges where the variation margin of the futures contract is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately.
iii. Open foreign currency futures contracts hedging foreign currency exposure on item(s) denominated in a foreign currency and translated into U.S. dollars (where the immediate recognition method of accounting is not being used):

(a) The foreign exchange premium (discount) on the currency contract will be amortized into investment income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. The cumulative income recognized since the contract was opened shall be reported as recognized variation margin received or (paid).

Amortization is not required if the contract was entered into within a year of maturity;

(b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as is done to translate the hedged item. The cumulative unrealized gain/(loss) which equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened shall be reported as recognized variation margin received or (paid);

(c) The statement value of the currency futures contract is book value, including any increase (decrease) for amortization of foreign exchange (premium) discount plus the foreign exchange translation gain/(loss), which is reported as deferred variation margin;

(d) Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs;

(e) For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value would equal the cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding;

(f) If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized in earnings equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

iv. Open derivatives hedging items recorded at market value, where gains and losses on the hedging item are recognized currently in earnings and for open derivatives accounted for under the immediate recognition method, futures shall be valued at current market value (marked to market) with changes in market value recognized currently in earnings.
c. Gain/Loss on Termination of a futures contract accounted for under hedge accounting:

i. Settlement at maturity of a futures contract—The remaining variation margin of the futures contract shall become an adjustment to the cost or proceeds of the hedged item(s) received, disposed of or held, individually or in aggregate;

ii. Sale or other closing transaction of a futures contract which is an effective hedge—Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate;

iii. Gain/loss on termination of futures contracts will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges;

Income Generation Transactions

General

29. Income generation transactions are defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock which it already owns).

30. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, offsetting assets and additional constraints are imposed requiring that the transactions be “covered” (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.

31. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

32. The principal features of income generation transactions are:

a. Premium received is initially recorded as a deferred liability;

b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., bonds);

c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;

d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Written Fixed Income Covered Call Options

33. The principal features of written fixed income covered call options are:

a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract;

b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst
amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;

c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;

d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset’s book value, the asset shall be evaluated for write down or disclosure treatment in accordance with SSAP No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect unassigned funds (surplus) and income shall be considered.
34. Written fixed income covered call options shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)</td>
<td></td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
</tbody>
</table>

Notes

1. Reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB—Part B.


3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.
Written Covered Put Options

35. The principal features of written covered put options are:
   a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;
   b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;
   c. As with covered call writing, entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy.

36. Written covered put options shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>UNDERLYING INTEREST VALUED AT AMORTIZED COST</th>
<th>UNDERLYING INTEREST VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust acquisition cost by premium received.</td>
<td>Adjust acquisition cost by premium received.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

Notes

1. Reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB—Part B.
Written Fixed Income Caps And Floors

37. The principal features of written fixed income caps and floors are:
   a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the entity is selling off possible excess interest/income, the value of the covering asset is not relevant;
   b. Gain/loss may be subject to IMR. The expected maturity would be the derivative contract’s maturity.

38. Written fixed income caps and floors shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value. (Alternatively carry at consideration received if within 1 year of maturity.)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Amortize over life of contract to produce constant yield.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Record any interest expense as “Other Investment Income” – negative value.</td>
<td></td>
</tr>
<tr>
<td>Closed – Matured</td>
<td>Would usually mature at zero amortized value.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Not applicable.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain/loss on termination to flow through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

39. Examples of accounting and presentation based on varying assumptions can be found in the October 1, 1996 minutes of the Accounting Practices and Procedures (EX4) Task Force.
Insurance Futures and Insurance Futures Options

General

40. Accounting for futures or options is similar to that of insurance futures or insurance futures options accounting. However, for purposes of this statement, insurance futures are viewed as insurance-related transactions and not as investment-related transactions. This distinction results in different reporting for the results of insurance futures and insurance futures options. As a result separate guidance is provided for insurance futures and insurance futures options.

41. Insurers generally use insurance futures or insurance futures options, to hedge against adverse development in incurred losses. This strategy typically would involve any or a combination of:

   a. The purchase of insurance futures contracts;
   b. The purchase of a call option on insurance futures contracts;
   c. The sale (writing) of a put option on insurance futures contracts.

Insurance Futures Contracts

42. An insurance futures contract is a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto. In connection with a given insurance futures position, a reporting entity is required by the listing exchange to maintain a margin deposit with respect to the underlying insurance futures contracts purchased.

43. A reporting entity shall report the amount of any margin deposit as an asset. The specific accounting treatment of increases or decreases in the value of the subject contracts will depend on whether the insurance futures position constitutes a hedge of the reporting entity’s incurred losses. The determination of whether an insurance futures position constitutes a hedge shall be made consistent with the criteria identified in paragraphs 17 through 19.

Insurance Futures Contracts—Hedge Accounting

44. Increases (decreases) in the value of insurance futures contracts that effectively hedge incurred losses shall be reported as an increase (decrease) in other income when the insurance futures position corresponds to incurred losses for the current reporting period. With respect to any insurance futures position which corresponds to a period beyond the current reporting period, any increases (decreases) in the value of the underlying insurance futures contracts shall be reported as a direct increase (decrease) in unassigned funds (surplus). When the insurance futures position thereafter corresponds to a current reporting period, the initial increase (decrease) in direct unassigned funds (surplus) shall be reversed and the amount shall be reported as an increase (decrease) to other income for the current period, along with any current changes in value of the insurance futures contracts.

45. In either of the foregoing instances, the increase (decrease) in the market value of the insurance futures contracts shall either (a) increase (decrease) other than invested assets, to the extent that such increase (decrease) affects the corresponding margin deposit, or (b) increase (decrease) cash or other assets, to the extent of mark-to-market payments that are not maintained as a margin deposit. When the insurance futures position is closed, any corresponding margin balance shall be transferred to cash or other assets, as appropriate.
Insurance Futures Contracts—Other than Hedge Accounting

46. If the insurance futures position is no longer effective as a hedge, any increases (decreases) in the value of the insurance futures contract shall be reported as miscellaneous income. When the insurance futures positions close, any corresponding margin balance shall be transferred to cash or other assets, as appropriate.

Options on Insurance Futures Contracts

47. An insurance futures option is either a put or a call option on an insurance futures contract. An insurance futures call option is a contract under which the holder has the right to purchase the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date. An insurance futures put option gives the holder the right to sell the underlying insurance futures contract. The consideration paid (received) for the purchase (sale) of an insurance futures option is referred to as a premium. Because all insurance futures options relate to an underlying insurance futures contract, the accounting treatment of insurance futures options generally follows the treatment afforded insurance futures contracts.

48. The amount of any premium paid for an insurance futures option shall be reported as other than invested assets. Similarly, the amount of any premium received for the sale (writing) of an insurance futures option shall be reported as a liability. The specific statutory accounting treatment of increases or decreases in the market value of the subject insurance futures option shall depend on whether such position constitutes a hedge of incurred losses. The determination of whether an insurance futures position constitutes a hedge shall be made consistent with the criteria identified in paragraphs 17 through 19.

Options on Insurance Futures Contracts—Hedge Accounting

49. Increases (decreases) in the market value of call options purchased, which effectively hedge incurred losses, shall be reported as an increase (decrease) in other income, when the call options correspond to incurred losses for the current reporting period. With respect to any call option which corresponds to a period beyond the current reporting period, any increases (decreases) in the market value of the underlying option shall be reported as a direct increase (decrease) in unassigned funds (surplus). When the option thereafter corresponds to a current reporting period, the initial increase (decrease) in direct unassigned funds (surplus) shall be reversed and the amount shall be reported as an increase (decrease) to other income along with any current changes in the market value of the option.

50. If the option position is terminated through a closing transaction, the corresponding balance of the asset (i.e., aggregate write-in for other than invested assets) shall be eliminated, with a corresponding charge to either (a) insurance futures margin, to the extent of margin deposit requirements, or (b) cash or other assets, as appropriate. If the option is exercised, the corresponding balance of the asset (i.e., aggregate write-in for other than invested assets) shall be eliminated, with a corresponding charge to the reporting entity’s other income.

51. The accounting treatment for the sale (writing) of insurance futures put options is essentially the mirror image of the foregoing treatment presented with respect to purchased call options. Upon termination (through a closing transaction), exercise, or expiration of the put option, the corresponding balance of the liability shall be eliminated, in the mirror image of the foregoing treatment.
Options on Insurance Futures Contracts—Other than Hedge Accounting

52. If the insurance futures option position is no longer effective as a hedge, any increases (decreases) in the value option shall be reported as miscellaneous income. Other than hedge accounting shall be used in the event that an original hedge position loses its character as such, until such time as the position is terminated.

Documentation Guidance

53. A reporting entity shall maintain documentation and records relating to derivatives opened during the year, instruments outstanding at year end, and instruments terminated during the year. Minimum required documentation is described in the following paragraphs.

54. For derivatives opened during the year:

a. A description, for each instrument, of the purpose of the transaction, including:
   i. A brief description of the assets and/or liabilities hedged by the instrument;
   ii. A brief description of the manner in which the instrument reduces risk;
   iii. A reference to the reporting entity’s hedge program under which such transaction is internally authorized.

b. Signature of approval, for each instrument, by person(s) authorized, either by the entity’s board of directors or a committee authorized by the board, to approve such transactions;

c. A description, for each instrument, of the nature of the transaction, including:
   i. The date of the transaction;
   ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
   iii. Number of contracts or notional amount;
   iv. Date of maturity, expiry or settlement;
   v. Strike price, rate or index, (opening price for futures contracts);
   vi. Counterparty, or exchange on which the transaction was traded;
   vii. Cost or consideration received, if any, for opening transaction.

d. A description of the reporting entity’s methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.
55. For derivatives terminated during the year:
   a. Signature of approval, for each instrument, by person(s) authorized, either by the entity’s board of directors or a committee authorized by the board, to approve such transactions;
   b. A description, for each instrument, of the nature of the transaction, including:
      i. The date of the transaction;
      ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
      iii. Number of contracts or notional amount;
      iv. Date of maturity, expiry or settlement;
      v. Strike price, rate or index, (termination price for futures contracts);
      vi. Counterparty, or exchange on which the transaction was traded;
      vii. Consideration paid or received, if any, on termination.
   c. Description of the reporting entity’s methodology to verify that derivatives were effective hedges;
   d. Identification of any derivatives that ceased to be effective as hedges.

56. For derivatives open at year end:
   a. A description of the methodology used to verify the continued effectiveness of hedges;
   b. An identification of any derivatives which have ceased to be effective as hedges;
   c. A description of the reporting entity’s methodology to determine market values of derivatives;
   d. Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Disclosures

57. Reporting entities shall disclose the following for all derivative contracts outstanding:
   a. Disclosures by category of instrument:
      i. Notional or contract amounts;
      ii. Carrying and fair values;
      iii. A description of the accounting policies for derivatives;
      iv. A discussion of the market risk, credit risk, and cash requirements of the derivatives.
b. General Disclosures:
   
i. A description of the reporting entity’s objectives for holding or issuing the derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivatives used;
   
ii. A description of how each category of derivative is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives held or issued, and when recognized, where those instruments and related gains and losses are reported.
   
58. Reporting entities shall disclose the following for derivatives held for other than hedging purposes:
   
a. Average fair value of the derivatives during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;
   
b. Net gains or losses disaggregated by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.
   
59. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.
   
60. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure requirements of paragraphs 58 and 59 shall be included in the annual audited statutory financial reports only.

Relevant Literature

61. This statement adopts 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) for all financial instruments with off-balance sheet risk with modification to the disclosure required in paragraph 17 to require that the disclosure distinguish between derivatives entered into for hedging purposes from those entered into for other than hedging purposes. Paragraph 19 is rejected as it addresses voluntary disclosures not required by this statement.

62. This statement adopts FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments (FAS 119) with the modification to the disclosure required in paragraph 8 to distinguish between derivatives entered into for hedging purposes from those entered into for other than hedging purposes. The disclosures required for trading derivatives by paragraph 10 of FAS 119 shall be required for derivatives entered into for other than hedging purposes. Paragraphs 12 and 13 are rejected. This statement also adopts FASB Emerging Issues Task Force No. 84-7, Termination of Interest Rate Swaps and FASB Emerging Issues Task Force No. 84-36, Interest Rate Swap Transactions.

63. This statement rejects FASB Statement No. 52, Foreign Currency Translation, FASB Statement No. 80, Accounting for Futures Contracts and the following FASB Emerging Issues Task Force pronouncements:
   
a. FASB Emerging Issues Task Force No. 84-14, Deferred Interest Rate Setting;
   
b. FASB Emerging Issues Task Force No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions;
c.  FASB Emerging Issues Task Force No. 87-2, Net Present Value Method of Valuing Speculative Foreign Exchange Contracts;

d.  FASB Emerging Issues Task Force No. 88-8, Mortgage Swaps;

e.  FASB Emerging Issues Task Force No. 90-17, Hedging Foreign Currency Risk with Purchased Options;

f.  FASB Emerging Issues Task Force No. 91-1, Hedging Intercompany Foreign Currency Risks;

g.  FASB Emerging Issues Task Force No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions;

h.  FASB Emerging Issues Task Force No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115.

Effective Date and Transition

64.  This statement is effective for years beginning January 1, 2001. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

AUTHORITATIVE LITERATURE

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

- FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments

- FASB Emerging Issues Task Force No. 84-7, Termination of Interest Rate Swaps

- FASB Emerging Issues Task Force No. 84-36, Interest Rate Swap Transactions

RELEVANT ISSUE PAPERS

- Issue Paper No. 85—Derivative Instruments
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Statement of Statutory Accounting Principles No. 33

Securitization

STATUS

Type of Issue: Common Area
Issued: Initial Draft
Effective Date: January 1, 2001
Affects: No other pronouncements
Affected by: Superseded by SSAP No. 91R
Interpreted by: INT 01-04, INT 01-31

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Securitization

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for asset securitizations and securitizations of policy acquisition costs. This statement is not intended to address transfers accomplished by means other than securitization.

SUMMARY CONCLUSION

2. An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities.

Accounting for Securitizations of Financial Assets

3. A financial asset shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both

   a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with the second entity; and

   b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.

4. A securitization in which the transferor surrenders control over the financial asset transferred shall be accounted for as a sale, with recognition of proceeds and measurement of a gain or loss only to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The portion of the securitization for which beneficial interests in the transferred assets are received shall not be accounted for as a sale, but shall be treated as an exchange of assets with no measurement of a gain or loss. All other securitizations shall be accounted for as secured borrowings in accordance with paragraph 11.

5. The transferor has surrendered control if, and only if, all of the following conditions are met:

   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;

   b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests; and

   c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that entitles and obligates the transferor to repurchase or redeem them before their maturity, or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

6. A beneficial interest shall be defined as the right to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest or principal inflows to be “passed through” or “paid through,” premiums due guarantors, and residual interests. Residual interests are interests in the cash flows of the trust or other entity, after the cash flows of structured securities issued by the trust are met.
7. Upon completion of the securitization of financial assets meeting the criteria for sales treatment required by paragraph 5, the transferor shall:
   a. Eliminate the transferred assets from the statement of financial position;
   b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;
   c. Record in its statement of financial position, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);
   d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 7 c.) and liabilities incurred in consideration as proceeds of the sale;
   e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and
   f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses line in the Investment Income section of the Underwriting and Investment Exhibit.

8. The successor (transferee) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.

9. A qualifying special-purpose entity (including a CMO special-purpose entity) as used in this statement must meet all of the following conditions:
   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
      i. Holding title to transferred financial assets;
      ii. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.);
      iii. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held; and
      iv. Distributing proceeds to the holders of its beneficial interests.
   b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is
not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

**Investments in Special-Purpose Entities**

10. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 88—*Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 46*. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25—*Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

**Secured Obligations and Collateral**

11. Securitizations of financial assets that do not meet the criteria for sale treatment set forth in paragraph 5 shall be presumed to be secured borrowings and shall be recorded as follows. Financial assets shall remain on the reporting entity’s books and a liability shall be recorded to reflect the proceeds from the issuance of any type of certificate. Non-cash proceeds shall be recorded as a contra liability and netted against the liability. The liability shall be reduced as the obligation to holders of beneficial interests is repaid. Financial assets pledged as collateral shall not be offset against the liability reflecting the proceeds of the transaction.

**Recognition of Servicing Rights**

12. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). The servicing asset or liability shall be measured in a manner consistent with paragraphs 13 and 35 through 38 of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125).

**Sales of Future Revenues**

13. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.
Relevant Literature

14. This statement adopts portions of FAS 125, with the following modifications (FAS 125 is addressed in its entirety in SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities):

   a. This statement requires servicing rights assets to be nonadmitted;

   b. This statement does not permit sales treatment for transactions where recourse provisions exist or where “call” or “put” options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

   c. This statement requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FAS 125 requires the encumbered assets to be reported separately from unencumbered assets;

   d. This statement does not address transfers of financial assets accomplished in a manner other than through securitizations whereas FAS 125 does address such transfers; and

   e. Paragraph 14 is rejected as it is not applicable.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

RELEVANT ISSUE PAPERS

- Issue Paper No. 86—Securitization
Statement of Statutory Accounting Principles No. 45

Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements

STATUS

Type of Issue: Common Area
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Effective Date: January 1, 2001
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Affected by: Superseded by SSAP No. 91R
Interpreted by: INT 00-11, INT 01-31

SCOPE OF STATEMENT

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AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

RELEVANT ISSUE PAPERS
Scope of Statement

1. This statement establishes statutory accounting principles for repurchase and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements.

Summary Conclusion

2. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Repurchase Agreements

3. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date within 12 months of the purchase. For securities to be substantially the same, the criteria defined in paragraph 14 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

4. Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

5. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

6. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria defined in paragraph 14 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

7. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement. Although recording these transactions gross tends to inflate assets and liabilities, it more closely reflects the financing nature of the transactions and their associated leverage impact to the financial statements.
Collateral Requirements

8. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Reverse Repurchase Transaction

b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.

Dollar Repurchase Agreements

9. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 14, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

10. For the seller in a dollar reverse repurchase agreement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

11. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 14.

12. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.
13. For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of the purchase. Since the term of the agreement is limited to twelve months, it is accounted for as a short-term investment. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Criteria to Meet Substantially the Same

14. For debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same;

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder;

c. The debt instruments must bear the identical contractual interest rate;

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield;

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages; and

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.

Separate Transactions

15. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 3, 6, or 9 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

16. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

17. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64), or
b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System. Otherwise, separate assets and liabilities shall be recognized.

Disclosures

18. The following disclosures shall be made in the financial statements:
   a. If the reporting entity has entered into repurchase agreements, its policy for requiring collateral or other security;
   b. A description of the securities underlying the agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and
   c. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

19. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

20. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used In Certain Audit Guides and a Statement of Position.

21. This statement adopts paragraphs 9 through 13, 15 through 17, 23 through 25, 27 through 30 and 66 through 71 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125), as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements.

22. This statement adopts FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls. This statement is consistent with FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105 (FIN 39) (as it relates to reverse repurchase and repurchase agreements) and FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39 (FIN 41). FIN 39 and FIN 41 are adopted in SSAP No. 64.

23. This statement rejects paragraph 14 of FAS 125 as it relates to the classifications of securities under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115). FAS 115 is rejected in SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities.

Effective Date and Transition

24. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.
AUTHORITATIVE LITERATURE

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

RELEVANT ISSUE PAPERS

- Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
Statement of Statutory Accounting Principles No. 46

Investments in Subsidiary, Controlled, and Affiliated Entities

STATUS

Type of Issue: Common Area
Issued: Initial Draft
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Affected by: Superseded by SSAP No. 88
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Statutory Accounting
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RELEVANT ISSUE PAPERS
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Investments in Subsidiary, Controlled, and Affiliated Entities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in subsidiaries, controlled, and affiliated entities (hereafter referred to as SCA entities).

SUMMARY CONCLUSION

Definitions

2. Parent and subsidiary are defined as follows:
   a. Parent—An entity that directly or indirectly owns and controls the reporting entity;
   b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.

3. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48). Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

4. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

5. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18, provides guidance on determining when such evidence exists. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

6. Investments in SCA entities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

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.). Once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity cannot change the valuation method to another method without the approval of the domiciliary commissioner.
a. In order to use the market valuation approach for SCA entities, the following requirements apply:

i. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;

ii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for 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;

iii. Ownership percentages for determining the discount rate shall be measured at the holding company level;

iv. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;

v. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;

vi. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required. 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

vii. 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 SSAP No. 68—Business Combinations and Goodwill (SSAP 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 SSAP No. 68. Examples include but are not limited to: (i) an insurer and a SCA entity that leases autos, furniture, office equipment, or computer equipment to the insurer; (ii) an insurer and a SCA entity that owns real estate property that is leased to the insurer for office space; and (iii) an insurer and an SCA entity that holds investments that 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: (i) a property-casualty or life insurer and a SCA entity that is an oil and gas venture; and (ii) a property-casualty insurer or life insurer and a SCA manufacturer.

8. This statement requires that investments 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 statement to noninsurance SCA entities, the focus is on the primary operations of the SCA for purposes of determining if it is required to be accounted for 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. This rule requires judgment by the reporting entity in making the determination and provides flexibility to the regulator in analyzing the determination.

9. For investments in entities recorded based on the underlying audited GAAP equity of the investee, the amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in SSAP No. 68). The carrying amount of the investment shall be adjusted to recognize the reporting entity’s share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity’s share of adjustments that are recorded directly to the investee’s stockholder’s equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded directly to unrealized capital gains and losses on investments.

10. The statutory equity method as described in subparagraph 7 b. i. shall be applied by recording an initial and subsequent investment in an investee at cost, which is defined in SSAP No. 68 as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. After the date of acquisition, the investment amount shall be adjusted for the amortization of goodwill and the reporting entity’s share of the change in special surplus funds, other than special surplus funds and unassigned funds (surplus), as defined in SSAP No. 72—Surplus and Quasi-Reorganizations. This represents the carrying amount of the investment.

11. To apply the equity method of accounting to investees as described in subparagraph 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 13.

12. 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.
13. The procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 7 b. i. through 7 b. iii.), 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 SSAP No. 68;

   b. A transaction of an investee of a capital nature that affects the reporting entity’s share of stockholders’ equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity’s equity ownership in the investee, the reporting entity’s recorded investment shall be adjusted to reflect the transaction);

   c. Realized gains or losses on the sale of an investment in a SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss;

   d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee’s current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period;

   e. A reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

   f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee’s preferred dividends, whether or not such dividends are declared;

   g. An investment in a SCA entity may fall below the level of ownership described in paragraph 4 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 prescribed 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.

14. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a downstream SCA entity, the directly held entity, which owns the parent’s shares, shall have its value reduced for the reciprocal ownership.

15. 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

16. When there is a decline in the fair value of an asset owned by a SCA entity that is other than temporary, the SCA entity shall write the asset down to fair value.

17. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Consolidation

18. Majority-owned subsidiaries shall not be consolidated for individual entity statutory reporting. This does not exempt certain reporting entities that are members of an affiliated group from the requirement to issue consolidated or combined annual statements as supplemental information in accordance with NAIC guidelines.

Disclosures

19. The significance of an investment to the reporting entity’s financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying
SSAP No. 46  

Superseded SSAPs and Nullified Interpretations

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; and

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.

20. Any commitment or contingent commitment to a SCA entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

21. 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; and

   b. The amount of the impairment and how fair value was determined.

22. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 19 d. above shall be included in the annual audited statutory financial reports only.

Relevant Literature

23. This statement adopts the Purposes and Procedures Manual of the NAIC Securities Valuation Office.

24. This statement adopts FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18 as guidance to be considered in determining the existence of control.

25. This statement rejects APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, 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.

Effective Date and Transition

26. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Correction of Errors.

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AUTHORITATIVE LITERATURE

Statutory Accounting

- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*

Generally Accepted Accounting Principles

- *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*

RELEVANT ISSUE PAPERS

- *Issue Paper No. 1—Consolidation of Majority-owned Subsidiaries*

- *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*
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Statement of Statutory Accounting Principles No. 79

Depreciation of Nonoperating System Software—An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software

STATUS

Type of Issue: Common Area

Issued: Finalized December 4, 2000

Effective Date: January 1, 2001

Affects: Supersedes paragraphs 3 and 8 of SSAP No. 16

Affected by: Paragraph 4 superseded by SSAP No. 87

Fully superseded by SSAP No. 16R

Interpreted by: INT 01-18, INT 01-21

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SSAP No. 79

Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the depreciation of EDP equipment, operating system software and nonoperating system software.

SUMMARY CONCLUSION

2. This statement supersedes paragraphs 3 and 8 of SSAP No. 16. The guidelines outlined in paragraphs 3 through 5 of this statement shall be followed for depreciation of EDP equipment, operating system software and nonoperating system software.

3. EDP equipment and operating system software shall be depreciated over the lesser of its useful life or three years. Nonoperating system software shall be depreciated over the lesser of its useful life or five years. In either case, the methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements (SSAP No. 19) shall be used.

4. In accordance with the reporting entity’s capitalization policy, immaterial amounts may be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

Effective Date and Transition

5. This statement is effective for years beginning January 1, 2001. EDP equipment and operating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or three years. Nonoperating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or five years.

RELEVANT ISSUE PAPER

- Issue Paper No. 109—Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software
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Statement of Statutory Accounting Principles No. 81

Software Revenue Recognition

STATUS
Type of Issue: Common Area
Issued: Finalized March 26, 2001
Effective Date: January 1, 2002
Affects: No other pronouncements
Affected by: Fully superseded by SSAP No. 16R
Interpreted by: INT 04-13, INT 04-18

...
Superseded SSAPs and Nullified Interpretations

H-81-3

Software Revenue Recognition

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for recognition of revenue from software.

SUMMARY CONCLUSION

2. This statement adopts AICPA Statement of Position 97-2, Software Revenue Recognition paragraphs 6 through 91 with certain modifications; AICPA Statement of Position 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions paragraphs 6 through 8; and FASB Emerging Issues Task Force 00-3, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware in its entirety. This statement rejects AICPA Statement of Position 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition as not applicable because the effective date is inconsistent with this statement.

3. The modifications to SOP 97-2 are as follows:
   a. Paragraph 10 is amended to require that entities follow the guidance outlined in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets rather than Statement of Financial Accounting Standard (FAS) No. 5, Accounting for Contingencies;
   b. Paragraph 33 is amended to remove the reference to Technical Bulletin No. 79-10, Fiscal Funding Clauses in Lease Agreements;
   c. Paragraph 57 is amended to remove the reference to FAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed;
   d. Paragraph 73 is rejected as not applicable to statutory accounting.

Effective Date and Transition

4. This statement is effective for years beginning January 1, 2002. Early adoption is encouraged but not required. Any change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

AUTHORITATIVE LITERATURE

- AICPA Statement of Position 97-2, Software Revenue Recognition
- AICPA Statement of Position 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition
- AICPA Statement of Position 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions
- FASB Emerging Issues Task Force 00-3, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware
RELEVANT ISSUE PAPER

- Issue Paper No. 111—Software Revenue Recognition
Statement of Statutory Accounting Principles No. 82

Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs

STATUS
Type of Issue: Common Area
Issued: Finalized March 26, 2001
Effective Date: January 1, 2002
Affects: No other pronouncements
Affected by: Paragraph 4 superseded by SSAP No. 87
Fully superseded by SSAP No. 16R
Interpreted by: INT 08-04

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Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the costs of computer software developed or obtained for internal use and web site development costs.

SUMMARY CONCLUSION

2. This statement adopts AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (SOP 98-1) paragraphs 11 through 42 and paragraph 93 with certain modifications. This statement adopts FASB Emerging Issue Task Force 00-2, Accounting for Web Site Development Costs in its entirety.

3. The modifications to SOP 98-1 are as follows:
   a. Paragraph 11 states that the accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP. This statement expands upon that paragraph to require that such costs shall be expensed as incurred;
   b. Paragraph 32 is amended to require that entities who license internal-use computer software follow the operating lease provisions outlined in SSAP No. 22—Leases;
   c. Paragraph 36 is amended to require that entities follow the amortization guidelines as established in paragraph 9 of SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements;
   d. Paragraph 37 is amended to require that capitalized operating system software shall be depreciated for a period not to exceed three years. Capitalized nonoperating system software shall be depreciated for a period not to exceed five years. This treatment is consistent with the guidelines of SSAP No. 16—Electronic Data Processing Equipment and Software (SSAP No. 16) and SSAP No. 79—Depreciation of Nonoperating System Software—An Amendment to SSAP No. 16, Electronic Data Processing Equipment and Software;
   e. Paragraph 40 is amended to require that if during the development of internal-use software, an entity decides to market the software to others, the entity shall immediately expense any amounts previously capitalized;
   f. Paragraph 41 is amended to require entities to follow the disclosure provisions outlined in paragraph 5 of SSAP No. 16 and paragraph 4 of SSAP No. 17—Preoperating and Research and Development Costs;
   g. Paragraph 42 is amended to require an effective date of January 1, 2002; and
   h. Any software costs capitalized in accordance with this SSAP shall be deemed either operating or nonoperating system software costs. Entities shall make this determination in accordance with the definitions of operating and nonoperating system software contained in the Glossary. Nonoperating system software is a nonadmitted asset in accordance with SSAP No. 16.
4. In accordance with the reporting entity’s capitalization policy, immaterial amounts of such costs can be expensed when incurred.

**Effective Date and Transition**

5. This statement is effective for years beginning January 1, 2002. Early adoption is encouraged but not required. Any change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

**AUTHORITATIVE LITERATURE**

- *AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

- *FASB Emerging Issue Task Force 00-2, Accounting for Web Site Development Costs*

**RELEVANT ISSUE PAPER**

- *Issue Paper No. 112—Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs*
Statements of Statutory Accounting Principles No. 88

Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46

STATUS

Type of Issue: Common Area
Issued: June 14, 2004
Effective Date: January 1, 2005
Affects: Supersedes SSAP No. 46
Supersedes the title and paragraphs 2 and 3 of SSAP No. 32
Supersedes SSAP No. 68 paragraphs 4, 5 and 6
Nullifies INT 99-03
Nullifies INT 99-28
Nullifies INT 00-01
Nullifies INT 01-22
Nullifies INT 01-24

Affected by: Superseded by SSAP No. 97
Interpreted by: INT 99-00, INT 00-24, INT 01-07, INT 02-07, INT 03-03, INT 03-16, INT 04-10, INT 06-07

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Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 46

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in subsidiaries, controlled and affiliated entities, hereinafter referred to as SCA entities.

2. This statement supersedes the conclusions reached in SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46).

SUMMARY CONCLUSION

Definitions

3. Parent and subsidiary are defined as follows:
   a. Parent—An entity that directly or indirectly owns and controls the reporting entity;
   b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.

4. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48). Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

5. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

6. Control as defined in paragraph 5 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. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:
   a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
   b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
c. An entity where the insurer has given up participating rights\(^1\) as a shareholder to the investee.

7. Investments in SCA entities meet the definition of assets as defined in SSAP No. 4— Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Applying the Market Valuation, Audited Statutory Equity and Audited GAAP Equity Methods

8. The admitted investments in SCA entities shall be recorded using either the market valuation approach (as described in paragraph 8 a.), or one of the equity methods (as described in paragraph 8 b.).

a. In order to use the market valuation approach for SCA entities, the following requirements apply:

i. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;

ii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for its calculation of the subsidiary’s market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;

iii. Ownership percentages for determining the discount rate shall be measured at the holding company level;

iv. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;

v. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;

vi. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required.

vii. Further, the SCA must have at least two million shares outstanding, with a total market value of at least $50 million in the public’s control; and

viii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.

b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 8 a. or, if the requirements are met, but a reporting entity elects not to use that

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\(^1\) The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in EITF 96-16, 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. The term “participating rights” shall be used consistent with the discussion of substantive participating rights in this EITF.
approach, the reporting entity’s proportionate share of its investments in SCAs shall be recorded as follows:

i. Investments in U.S. insurance SCA entities shall be recorded based on the underlying audited statutory equity of the respective entity’s financial statements, adjusted for any unamortized goodwill as provided for in SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68). Reporting entities shall record investments in U.S. insurance SCA entities on at least a quarterly basis, and shall base the investment value on the most recent quarterly information available from the SCA. Entities may recognize their investment in U.S. insurance SCA entities based on the unaudited statutory equity in the SCAs year-end Annual Statement if the annual SCA audit is not complete as of the filing deadline. The recorded statutory equity shall be adjusted for audit adjustments, if any, as soon as the annual audit has been completed. Annual consolidated audits are allowed if completed in accordance with the Model Regulation Requiring Annual Audited Financial Reports as adopted by the SCA’s domiciliary state;

ii. Investments in noninsurance SCA entities that are engaged in the following transactions or activities:

(a) Collection of balances as described in SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

(b) Sale/lease or rental of EDP Equipment and Software as described in SSAP No. 16—Electronic Data Processing Equipment and Software and SSAP No. 79—Depreciation of Nonoperating System Software

(c) Sale/lease or rental of furniture, fixtures, equipment or leasehold improvements as described in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

(d) Loans to employees, agents, brokers, representatives of the reporting entity or SCA as described in SSAP No. 20—Nonadmitted Assets

(e) Sale/lease or rental of automobiles, airplanes and other vehicles as described in SSAP No. 20—Nonadmitted Assets

(f) Providing insurance services on behalf of the reporting entity including but not limited to accounting, actuarial, auditing, data processing, underwriting, collection of premiums, payment of claims and benefits, policyowner services

(g) Acting as an insurance or administrative agent or an agent for a government instrumentality performing an insurance function (e.g. processing of state workers compensations plans, managing assigned risk plans, Medicaid processing etc).

(h) Purchase or securitization of acquisition costs

and if 20% or more of the SCA’s revenue is generated from the reporting entity and its affiliates, then the underlying equity of the respective entity’s audited
Generally Accepted Accounting Principles (GAAP) financial statements shall be adjusted to a statutory basis of accounting (refer to paragraph 9). For purposes of this section, revenue means GAAP revenue reported in the audited GAAP financial statements excluding realized and unrealized capital gains/losses. Paragraphs 17 through 19 provide guidance for investments in holding companies;

iii. Investments in noninsurance SCA entities that do not qualify under subparagraph 8 b. ii. shall be recorded based on the audited GAAP equity of the investee;

iv. Investments in foreign insurance SCA entities shall be recorded based on the underlying audited U.S. GAAP equity of the respective entity adjusted to a statutory basis of accounting in accordance with paragraph 9 and adjusted for reserves of the foreign insurance SCA with respect to the business it assumes directly and indirectly from a U.S. insurer using the statutory accounting principles promulgated by the NAIC in the Accounting Practices and Procedures Manual.

The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the annual audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in AICPA Statement of Auditing Standard No. 69, The Meaning of “Presents Fairly in Conformity With GAAP”. Foreign SCA entities are defined as those entities incorporated or otherwise legally formed under the laws of a foreign country. Foreign insurance SCA entities are defined as alien insurers formed according to the legal requirements of a foreign country. Investments in foreign noninsurance SCA entities shall follow the guidance in 8 b. ii., and 8 b. iii. above.

9. Statutory basis for accounting for investments in noninsurance SCA entities, subject to paragraph 8 b. ii. and foreign insurance SCA entities, subject to paragraph 8 b. iv., shall be based on the underlying audited U.S. GAAP equity of the respective entity with the following adjustments:

a. Nonadmit assets pursuant to the following statutory accounting principles as promulgated by the NAIC in the Accounting Practices and Procedures Manual;

i. SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

ii. SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

iii. SSAP No. 20—Nonadmitted Assets

iv. SSAP No. 29—Prepaid Expenses

v. SSAP No. 16—Electronic Data Processing Equipment and Software

vi. SSAP No. 79—Depreciation of Nonoperating System Software

b. Expense costs that are capitalized in accordance with GAAP but are expensed pursuant to statutory accounting as promulgated by the NAIC in the Accounting Practices and Procedures Manual (e.g., deferred policy acquisition costs);
c. Adjust depreciation for certain assets in accordance with the following statutory accounting principles:

i. SSAP No. 16—Electronic Data Processing Equipment and Software and SSAP No. 79—Depreciation of Nonoperating System Software

ii. SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

d. Nonadmit the amount of goodwill of the SCA in excess of 10% of the audited GAAP equity of the SCA’s last audited financial statements.

e. Nonadmit amount of the net deferred tax assets (DTAs) of the SCA in excess of 10% of the audited GAAP equity of the SCA’s last audited financial statements.

f. Adjust the GAAP annuity account value reserves of a foreign insurance SCA, with respect to the business it wrote directly, using the commissioners' annuity reserve valuation method (CARVM) as defined in paragraphs 12 and 13 of Appendix A-820 (including the reserving provisions in the various Actuarial Guidelines which support CARVM). The valuation interest rate and mortality tables to be used in applying CARVM should be that prescribed by the foreign insurance SCA's country of domicile. If the Foreign SCA’s country of domicile does not prescribe the necessary tables and/or rates, no reserve adjustment shall be made.

The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in AICPA Statement of Auditing Standards No. 69, The Meaning of “Presents Fairly in Conformity With GAAP.”

10. The audited statutory equity method as described in paragraph 8 b. i. and 8 b. ii. shall be applied by recording an initial and subsequent investment in an investee at cost (excluding any investment in an investee’s preferred stock and/or surplus notes), which is defined in SSAP No. 68 as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. Investments in an SCA’s preferred stock and/or surplus notes are addressed in paragraphs 20 and 21. After the date of acquisition, the investment amount shall be adjusted for the amortization of goodwill and the reporting entity’s share of the change in special surplus funds, other than special surplus funds and unassigned funds (surplus), as defined in SSAP No. 72—Surplus and Quasi-reorganizations, and as adjusted appropriately for the items in paragraph 9. This represents the carrying amount of the investment.

11. If the reporting entity is using an equity method (as described in paragraphs 8 b.i. through 8 b. iv.), 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 8 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.
12. For investments in entities recorded based on the underlying audited GAAP equity of the investee, the amount to be recorded shall be defined as the initial investment in an investee at cost (excluding any investments in an investee’s preferred stock), which is defined in SSAP No. 68. Investments in an SCA’s preferred stock are addressed in paragraphs 20 and 21. 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 a corresponding amount recorded directly to unrealized capital gains and losses on investments. For entities subject to paragraphs 8 b. ii. or 8 b. iv. additional adjustments are required in accordance with paragraph 9.

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8 b. i. through 8 b. iv.), as applicable, to investments in SCA entities:

   a. A difference between the cost of an investment and the underlying equity in the statutory or GAAP book value, as applicable, of the acquired company at the date of acquisition shall be accounted for in accordance with SSAP No. 68 however, positive goodwill for noninsurance SCA entities subject to paragraph 8 b. ii. and foreign insurance SCA entities subject to paragraph 8 b. iv. shall be subject the admissibility criteria in paragraph 9 d. rather than the admissibility criteria of paragraph 7 of SSAP No. 68.

   b. A transaction of an investee of a capital nature that affects the reporting entity’s share of stockholders’ equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity’s equity ownership in the investee, the reporting entity’s recorded investment shall be adjusted to reflect the transaction);

   c. Realized gains or losses on the sale of an investment in a SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss;

   d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee’s current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period. This paragraph does not apply to a SCA valued under paragraph 8 b. i.;

   e. For entities subject to 8 b. i., 8 b. iii. and 8 b. iv. 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 minus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;
f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee’s preferred dividends, whether or not such dividends are declared;

g. An investment in a SCA entity may fall below the level of ownership described in paragraph 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.

14. Once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity may not change the valuation method to another method without the approval of the domiciliary commissioner. For instance, if an entity selects the market valuation method, it may not change to an equity method or vice versa without approval from the domiciliary commissioner. Further, in order for an entity to transfer from a paragraph 8 a. or 8 b. ii. valuation to a paragraph 8 b. iii. valuation, the SCA shall not exceed the 20% threshold (as defined in paragraphs 8 b. ii.) for three consecutive years prior to making the change. 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.

15. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a downstream SCA entity, the directly held entity, which owns the parent’s shares, shall have its value reduced for the reciprocal ownership.

16. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a downstream affiliate, which in turn owns shares of the parent reporting entity, shall eliminate its interest in these shares from the valuation of such affiliate.

**Investments in Downstream Holding Companies**

17. Valuation of a downstream holding company depends upon the nature of the SCA entities it holds in accordance with paragraph 8 and the guidance contained in the applicable SSAP for non-SCA investments. If an SCA investment of the downstream holding company does not meet the provisions of paragraph 8 a. or if it elects not to use the guidance in paragraph 8 a., and instead uses the guidance in paragraph 8 b., then the downstream holding company would look to its underlying assets and record them as follows:

a. Investments by a holding company in U.S. insurance SCA entities are recorded based upon the guidance in paragraph 8 b. i.;

b. Investments by a downstream holding company in noninsurance SCA entities that are engaged in transactions or activities described in paragraph 8 b. ii., are recorded based upon the guidance in paragraph 8 b. ii.;
c. Investments by a downstream holding company in noninsurance SCA entities that do not qualify under paragraph 17 b. above shall be recorded based upon the guidance in paragraph 8 b. iii.; and

d. Investments by a downstream holding company in foreign insurance SCA entities shall be recorded based upon the guidance in paragraph 8 b. iv.

18. In lieu of separate GAAP audits of SCA entities of the downstream holding company, the insurer can choose to have a GAAP audit performed at the holding company level with a consolidating balance sheet showing GAAP equity of all the SCA entities. The consolidating balance sheet shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 8 b. ii., 8 b. iii and 8 b. iv. entities under the downstream holding company. This adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level insurance company.

19. A purchased downstream holding company is valued in accordance with the provisions of paragraph 17 and the provisions of SSAP No. 68.

**Investment in Preferred Stock or Surplus Notes of a Subsidiary, Controlled and Affiliated Entity**

20. When the reporting entity also holds an investment in preferred stock or surplus note(s) of an SCA and the carrying amount determined in accordance with paragraphs 8 b. and 9 includes preferred stock or surplus note(s), the investment in the SCA must be separated into its components. The carrying amount of the SCA is reduced by the value of the SCA’s preferred stock or surplus note(s).

21. Investments in the preferred stock of an SCA shall be accounted for and reported in accordance with the provisions of **SSAP No. 32—Investments in Preferred Stock** (SSAP No. 32). This statement amends the title of SSAP No. 32 as follows:

   **SSAP No. 32—Investments in Preferred Stock** (including investments in preferred stock of subsidiary, controlled, or affiliated entities)

This statement amends paragraphs 2 and 3 of SSAP No. 32 to the following:

2. Investments in preferred stock of subsidiaries, controlled or affiliated entities are included within the scope of this statement.

3. Preferred stock (including investment in affiliates), which may or may not be publicly traded and may include shares against which exchange traded call options are outstanding, shall include:

22. Investments in the surplus notes of an SCA shall be accounted for and reported in accordance with the provisions of **SSAP No. 41—Surplus Notes**.

23. The following example is provided to illustrate the accounting and reporting. The reporting entity holds 100% of the preferred stock. The SCA issued the preferred stock for $50,000. The investment in the SCA, measured in accordance with this SSAP is $250,000 including the preferred stock of the SCA. The investment in the SCA is $200,000 ($250,000-50,000) and the preferred stock is measured and reported in accordance with SSAP No. 32.

**Impairment**

24. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any
portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings, which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Consolidation

25. Majority-owned subsidiaries shall not be consolidated for individual entity statutory reporting. This does not exempt certain reporting entities that are members of an affiliated group from the requirement to issue consolidated or combined annual statements as supplemental information in accordance with NAIC guidelines.

Amendments to SSAP No. 68

26. This statement supersedes paragraphs 4 through 6 of SSAP No. 68—Business Combinations and Goodwill as follows:

4. For those acquired SCA entities accounted for in accordance with paragraphs 8 b. i., 8 b. ii., 8 b. iii. or 8 b. iv. of SSAP No. 88, 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.

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8 b. ii., 8 b. iii. or, 8 b. iv. of SSAP No. 88 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, 8 b. i. SSAP No. 88 shall determine the amount of positive or negative goodwill created by the business combination using the insurer’s share of the statutory book value of the acquired entity.

6. For those acquired SCA entities accounted for in accordance with paragraph 8 b. i. under the statutory purchase method the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.

Disclosures

27. The significance of an investment to the reporting entity’s financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying
equity in net assets (i.e., goodwill, other nonadmitted assets, market value or discounted market value adjustments) and the accounting treatment of the difference;

b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted market price and the difference, if any, between the amount at which the investment is carried and the quoted market price shall be disclosed;

c. Summarized information as to assets, liabilities, and results of operations shall be presented for SCA entities, either individually or in groups;

d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor’s share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity; and

e. For those SCA entities in which the reporting entity elected, or was required, to change its valuation method as described in paragraph 14, a description of the reason for the change and the amount of adjustment recorded as unrealized gains or losses shall be disclosed. The entity shall also disclose whether commissioner approval was obtained in accordance with paragraph 14.

28. A reporting entity that calculates its investment in a foreign insurance subsidiary by adjusting annuity GAAP account value reserves using CARVM and the related Actuarial Guidelines shall disclose the interest rates and mortality assumptions used in the calculation as prescribed by the insurance department of the foreign country.

29. Any commitment or contingent commitment to a SCA entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

30. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment and how fair value was determined.

31. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 27d. shall be included in the annual audited statutory financial reports only.

**Relevant Literature**

32. This statement adopts the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

33. This statement adopts *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18* as guidance to be considered in determining the existence of control.

34. This statement rejects *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, 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 Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights, and FASB Staff Position No. APB 18-1, Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence.

Effective Date and Transition

35. This statement is effective for years beginning on and after January 1, 2005. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

AUTHORITATIVE LITERATURE

Statutory Accounting

- Purposes and Procedures Manual of the NAIC Securities Valuation Office

Generally Accepted Accounting Principles

- FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18

RELEVANT ISSUE PAPERS

- Issue Paper No. 118—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46
ILLUSTRATION OF ACCOUNTING FOR SCAS

This illustration, accompanying this Statement, is intended to provide an example of the application of paragraphs 8 b. ii. and 8 b. iii. Where an SCA meets the criteria of 8 b. ii., the illustration further demonstrates the necessary adjustments described in paragraph 9. While not all inclusive, the illustration is representative of the process and adjustments necessary to comply with this Statement. That is, the reporting entity must, first, determine which sub-section of paragraph 8 applies with respect to each SCA. Secondly, where the reporting entity has determined that an SCA meets the criteria of section 8 b. ii. or 8 b. iv., then the carrying amount is adjusted in accordance with the sub-section, which includes adjustments contained in the provisions of paragraph 9.

The ABC Insurance Company owns 100% of three subsidiaries:

1. ABC Real Estate, Inc. – owns and manages real estate properties and has no inter-company transactions

2. U-Lease-It, Inc. – leases furniture and equipment to local businesses including the insurance company. Lease fees received from ABC were $10 million each in 20x2 and 20x1.

3. U-Rent-It, Inc. – leases EDP equipment to local businesses including the insurance company. Lease fees received from ABC were $2 million each in 20x2 and 20x1.
Determination and application of adjustments to audited GAAP equity methods (paragraph 8 b. of SSAP No. 88)

ABC Real Estate, Inc.-the company is not engaged in any activities described in 8 b. ii. No adjustments are made and ABC Insurance Company records its investment based upon audited GAAP equity in accordance with 8 b. iii.

U-Lease-It, Inc.-the company is engaged in activities described in 8 b. ii., leasing furniture and equipment. The fees paid by ABC and reflected in income of U-Lease-It, Inc. exceed 20% of GAAP revenue calculated as follows:

<table>
<thead>
<tr>
<th>U-Lease-It, Inc.</th>
<th>(Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20x1</td>
</tr>
<tr>
<td>GAAP revenue</td>
<td>46.5</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Realized capital gains/(losses)</td>
<td>6</td>
</tr>
<tr>
<td>Adjusted GAAP revenue</td>
<td>45.9</td>
</tr>
<tr>
<td>Lease fees from ABC</td>
<td>10.0</td>
</tr>
<tr>
<td>Fees/adjusted GAAP revenue</td>
<td>21.8%</td>
</tr>
</tbody>
</table>

U-Rent-It, Inc.-the company is engaged in activities described in 8 b.ii., leasing EDP equipment. The fees paid by ABC and reflected in income of U-Rent-It, Inc. do not exceed 20% of GAAP revenue. No adjustments are made and ABC Insurance Company records its investment based upon audited GAAP equity in accordance with 8 b. iii. The calculation test is as follows:

<table>
<thead>
<tr>
<th>U-Rent-It, Inc.</th>
<th>(Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20x2</td>
</tr>
<tr>
<td>GAAP revenue</td>
<td>32.6</td>
</tr>
<tr>
<td>Lease fees from ABC</td>
<td>2.0</td>
</tr>
<tr>
<td>Fees/GAAP revenue</td>
<td>6.1%</td>
</tr>
</tbody>
</table>

Adjustments to audited GAAP equity for U-Lease-It, Inc.

<table>
<thead>
<tr>
<th></th>
<th>(Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20x2</td>
</tr>
<tr>
<td>Audited GAAP equity</td>
<td>129</td>
</tr>
<tr>
<td>Nonadmit furniture &amp; equipment</td>
<td>(250)</td>
</tr>
<tr>
<td>Nonadmit excess goodwill *</td>
<td>(2)</td>
</tr>
<tr>
<td>Adjusted GAAP equity</td>
<td>(123)</td>
</tr>
</tbody>
</table>

*Goodwill adjustment - 20x2=$15- (10% x $130[20x1GAAP equity]) and 20x1=$15-(10% x $129.9 [20x0 GAAP equity])

Note: No DTA adjustment since the amount is less that 10% of GAAP equity
Schedule D affiliated common stocks for ABC Insurance Company

<table>
<thead>
<tr>
<th></th>
<th>20x2</th>
<th>20x1</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Real Estate Inc.</td>
<td>223</td>
<td>219</td>
</tr>
<tr>
<td>U-Lease-It, Inc.</td>
<td>(123)</td>
<td>(132)</td>
</tr>
<tr>
<td>U-Rent-It, Inc.</td>
<td>30</td>
<td>27</td>
</tr>
<tr>
<td>Total</td>
<td>130</td>
<td>114</td>
</tr>
</tbody>
</table>

Note: The change in carrying value between years of $16 million is reported as an unrealized gain in 20x2.
ILLUSTRATED BALANCE SHEETS

ABC Insurance Company

<table>
<thead>
<tr>
<th></th>
<th>20x2</th>
<th>20x1</th>
<th>20x2</th>
<th>20x1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Admitted Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>11,210</td>
<td>11,150</td>
<td>12,516</td>
<td>12,394</td>
</tr>
<tr>
<td>Common stock (unaffiliated)</td>
<td>325</td>
<td>315</td>
<td>30</td>
<td>29</td>
</tr>
<tr>
<td>Common Stock (affiliated)</td>
<td>130</td>
<td>114</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real estate</td>
<td>120</td>
<td>125</td>
<td>Expenses due and accrued</td>
<td>14</td>
</tr>
<tr>
<td>Mortgage loans</td>
<td>1,685</td>
<td>1,640</td>
<td>Misc. liabilities</td>
<td>250</td>
</tr>
<tr>
<td>Cash</td>
<td>10</td>
<td>7</td>
<td>Total liabilities</td>
<td>12,810</td>
</tr>
<tr>
<td>Sub-total</td>
<td>13,480</td>
<td>13,351</td>
<td>Common stock</td>
<td>100</td>
</tr>
<tr>
<td>Other assets</td>
<td>20</td>
<td>14</td>
<td>Unassigned funds</td>
<td>590</td>
</tr>
<tr>
<td>Total</td>
<td>13,500</td>
<td>13,365</td>
<td>Total equity</td>
<td>690</td>
</tr>
</tbody>
</table>

ABC Real Estate, Inc.

<table>
<thead>
<tr>
<th></th>
<th>20x2</th>
<th>20x1</th>
<th>20x2</th>
<th>20x1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>10</td>
<td>7</td>
<td>Notes payable</td>
<td>260</td>
</tr>
<tr>
<td>Bonds (available for sale)</td>
<td>110</td>
<td>103</td>
<td>Misc. liabilities</td>
<td>17</td>
</tr>
<tr>
<td>Real estate investments</td>
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## U-Lease-It, Inc.

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### Summary of Operations

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<td>Federal income tax benefit</td>
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<tr>
<td><strong>Net income</strong></td>
<td>(1.5)</td>
<td>(0.5)</td>
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<td>Unrealized capital gains/losses</td>
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U-Rent-It, Inc.

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<td>Bonds (available for sale)</td>
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<td>EDP equipment</td>
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<td>Accounts payable</td>
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**Summary of Operations**

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<tr>
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<tr>
<td>Revenues:</td>
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<td></td>
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<tr>
<td>Interest income</td>
<td>0.5</td>
<td>0.4</td>
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<tr>
<td>Lease fees</td>
<td>32.1</td>
<td>30.1</td>
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<td>Administration</td>
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<td>Depreciation</td>
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<td>Total</td>
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<td>Net income before taxes</td>
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<tr>
<td>Federal income tax</td>
<td>(1.3)</td>
<td>(1.0)</td>
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<tr>
<td>Net income</td>
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<td>2.0</td>
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<tr>
<td>Unrealized capital gains/losses</td>
<td>0.4</td>
<td>0.6</td>
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APPENDIX A TRANSITION GUIDANCE FOR YEAR-END 2006 REPORTING QUESTIONS AND ANSWERS

The National Association of Insurance Commissioners issued Statement of Statutory Accounting Principle No. 88—Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 46 (SSAP No. 88) with an effective date of January 1, 2005. This statement included a number of changes that have resulted in questions by reporting entities, auditors and regulators. The purpose of this appendix (Appendix A) is to provide transition guidance on areas that have not been interpreted or applied consistently. This appendix is intended to provide clear reporting guidance for year-end 2006 (and prior year 2005). The Statutory Accounting Principles Working Group intends to finalize work on SSAP No. 88 and complete the SSAP No. 88 Implementation Guide (planned as Appendix B) in 2007 for year-end 2007 and going forward.

Question 1. Is an audit of only the balance sheet acceptable to meet the SCA audit requirements of SSAP No. 88?

Answer 1. Yes, (for 2005 and 2006 reporting only). The Statutory Accounting Principles Working Group intended that in order to meet the requirements of SSAP No. 88, paragraphs 8 and 9, that audits be conducted in accordance with the Model Regulation Requiring Annual Audited Financial Reports, as adopted by the SCA’s domiciliary state, and in accordance with GAAP, as defined as those pronouncements included in the United States GAAP Hierarchy as described in AICPA Statement of Auditing Standards No. 69, The Meaning of “Presents Fairly in Conformity With GAAP.”

During the course of development of the SSAP No. 88 Implementation Guide, the Statutory Accounting Principles Working Group became aware that some reporting entities and independent accounting firms had interpreted the guidance relating to the equity value of subsidiaries to imply that an audit of only the balance sheet was sufficient to meet the audit requirements included in SSAP No. 88. An audited balance sheet will be deemed sufficient to meet the SCA audit requirements of SSAP No. 88 for subsidiaries reported under paragraphs 8.b.ii., 8.b.iii. and 8.b.iv., for year-end 2005 and 2006 reporting only. Note that U.S. insurance subsidiaries (paragraph 8.b.i entities) will continue to be required to meet applicable state laws regarding audit requirements. In addition, if an audit of the financial statements (i.e., balance sheet, summary of operations, statement of changes in capital and surplus, and cash flows) was obtained for 2005, then an audit of only the balance sheet is not sufficient for 2006.

Question 2a. If a downstream non insurance holding company is merely holding (1) subsidiary, controlled, and affiliated (SCA) entities and/or (2) joint ventures, partnerships, and/or limited liability companies in which the downstream non insurance holding company has a minor ownership interest or otherwise lacks control, i.e., ownership interest is less than 10% (hereinafter referred to as “non SCA SSAP No. 48 entities”), does not own any other additional assets, and is not held liable for any other liabilities, commitments, contingencies, guarantees or obligations of the investment in the downstream non insurance holding company, is an audit of the financial statements of the downstream non insurance holding company required, or is a “look-through” permitted?

Answer 2a. The Working Group is aware that many were confused by the meaning of the language in SSAP No. 88, paragraphs 17 and 18, and will clarify that language for 2007. The divergence in interpretation focused on the number of audits required under SSAP No. 88 for downstream subsidiary, controlled, and affiliated entities including holding companies.

Some believed that an audit of the financial statements of a downstream non insurance holding companies was not required if the downstream non insurance holding company was merely holding SCA entities and/or non SCA SSAP No. 48 entities and had no other assets or liabilities. In short, it was interpreted that the financial statements of the downstream non insurance holding company need not be audited if the
financial statements of the SCA entities and/or the non SCA SSAP No. 48 entities owned by the downstream non insurance holding company were audited, i.e., a “look-through” approach could be used. SSAP No. 88 indicates that SCA entities are to be valued using one of the valuation methods described in paragraph 8. All of the paragraph 8.b. valuation methods require the financial statements of SCA entities to be audited, including downstream non insurance holding companies, in order to be admitted assets. Likewise, SSAP No. 48 requires the financial statements of non SCA SSAP No. 48 entities to be audited (U.S. GAAP) in order to be admitted assets. For year-end 2005 and 2006 reporting only, it is acceptable to apply the “look through” approach for downstream non insurance holding companies that do not hold assets other than SCA entities and/or non SCA SSAP No. 48 entities, or liabilities, commitments, contingencies, guarantees or obligations, provided the financial statements of the SCA entities and/or the non SCA SSAP No. 48 entities are separately audited.

Question 2b. Can the “look-through” approach be applied to non insurance holding companies that hold assets other than SCA entities and/or liabilities, commitments, contingencies, guarantees or obligations? Can the “look-through” approach be applied to downstream non insurance holding companies that hold other unaudited immaterial investments?

Answer 2b. If a downstream non insurance holding company holds assets other than SCA entities and/or non SCA SSAP No. 48 entities, the financial statements of the downstream non insurance holding company shall be audited. If the financial statements of the downstream non insurance holding company are not audited, investments in unaudited SCA and/or unaudited non SCA SSAP No. 48 entities, as well as any other assets of the downstream non insurance holding company, are nonadmitted. All liabilities, commitments, contingencies, guarantees or obligations of the downstream non insurance holding company, which are required to be recorded as liabilities, commitments, contingencies, guarantees or obligations under applicable statutory accounting guidance, shall be reflected in the parent insurance reporting entity’s determination of the carrying value of the investment in the downstream non insurance holding company, if not already recorded in the financial statements of the downstream non insurance holding company.

Numerical Illustration to questions 2a and 2b:

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<th>Parent Insurance 8.b.i. Reporting Entity (Audited)</th>
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<tbody>
<tr>
<td>Downstream Non Insurance Holding Company (Not Audited)</td>
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<tr>
<td>GAAP 8.b.iii. Sub 1 (Audited)</td>
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<tr>
<td>Nine percent interest in an LLC (Audited)</td>
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### Downstream Non Insurance Holding Company Balance Sheet

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<tbody>
<tr>
<td>GAAP Sub 1</td>
<td>Miscellaneous</td>
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<tr>
<td>Nine percent interest in an audited LLC</td>
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<tr>
<td>Miscellaneous</td>
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<th><strong>Total Liabilities &amp; Equity</strong></th>
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<td>350</td>
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**Investment in Downstream Non Insurance Holding Company, including the investments in a SCA entity and a non SCA SSAP No. 48 entity** 150

**Calculation:**

Add:

- GAAP Sub 1 100
- Nine percent interest in an audited LLC 200
- Miscellaneous Liabilities 150

**Total** 300

Less:

- Miscellaneous Liabilities 150

**Net Investment in Downstream Non Insurance Holding Company, Including the investments in a SCA entity and a non SCA SSAP No. 48 entity** 150
Question 3. As illustrated below, would an audit of the consolidated financial statements of the Non Insurance Holding Company Parent with consolidating balance sheets of the insurance companies and GAAP Sub 1 and GAAP Sub 2 meet the requirements for audited financial statements of the subsidiaries under SSAP No. 88, paragraph 18?

Answer 3. No. It was never the intent of SSAP No. 88 to allow an audit of the consolidated financial statements of the non insurance holding company parent with consolidating balance sheets of the insurance company subsidiary, GAAP Sub 1 and GAAP Sub 2, and Statutory Sub to meet the requirements for audited financial statements of the subsidiaries under SSAP No. 88, paragraph 18.
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Statement of Statutory Accounting Principles No. 98

Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities

STATUS
Type of Issue: Common Area
Issued: November 5, 2008
Effective Date: January 1, 2009
Affects: Amends SSAP No. 43, paragraphs 14 through 16
Affected by: Superseded by SSAP No. 43R
Interpreted by: INT 00-11; INT 02-07; INT 06-07; INT 07-01

SCOPE OF STATEMENT

SUMMARY CONCLUSION

Impairment
Disclosures
Effective Date and Transition

RELEVANT ISSUE PAPERS
SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for impairment analysis and subsequent valuation of loan-backed and structured securities.

SUMMARY CONCLUSION

2. This statement amends paragraphs 14 through 16 of SSAP No. 43—Loan-Backed and Structured Securities to the following:

14. 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 the prospective 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 security is determined to be other than temporarily impaired.

15. 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

16. If it is determined that the decline in fair value of the security is other than temporary, then the cost basis of the security shall be written down to fair value. The amount of the write down shall be accounted for as a realized loss. An interest related decline in value shall be considered other than temporary only when a reporting entity has the intent to sell the investment, at the reporting date, before recovery of the cost of the investment. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. Credit related other than temporary impairment losses shall be recorded through the AVR; interest related other than temporary impairment losses shall be recorded through the 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.

Disclosures

3. This statement requires no additional disclosures.

Effective Date and Transition

4. This statement is effective for quarterly and annual reporting periods beginning on or after January 1, 2009, with early adoption permitted and encouraged. A change resulting from the adoption of this statement shall be accounted for prospectively. No cumulative effect adjustments or application of the new guidance to prior events or periods are required, similar to a change in accounting estimate.
RELEVANT ISSUE PAPERS

- Issue Paper No. 124—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, An Amendment to SSAP No. 43—Loan-Backed and Structured Securities
Statement of Statutory Accounting Principles No. 99

Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment

STATUS

Type of Issue: Common Area

Issued: September 23, 2008

Effective Date: January 1, 2009

Affects: Supersedes SSAP No. 26, paragraph 9 and SSAP No. 32, paragraphs 22-24 Amends SSAP No. 34, paragraph 3 Inserts new paragraph 17 in SSAP No. 43

Affected by: Paragraph 13 superseded by SSAP No. 43R Fully superseded – Guidance incorporated into SSAP Nos. 26, 32 and 34

Interpreted by: INT 06-07

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<th>SUMMARY CONCLUSION</th>
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Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment

SCOPE OF STATEMENT

1. This statement establishes the statutory accounting principles for the treatment of premium or discount applicable to certain securities subsequent to the recognition of an other-than-temporary impairment.

2. This statement supersedes the guidance in paragraph 9 of SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities (SSAP No. 26); paragraphs 22-24 of SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities) (SSAP No. 32); and paragraph 16 of SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 43). This statement modifies the guidance in paragraph 3 of SSAP No. 34—Investment Income Due and Accrued (SSAP No. 34).

SUMMARY CONCLUSION

3. This statement adopts the guidance in paragraph 16 of FASB Staff Position No. FAS 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1/124-1), with modification to the applicable statutory accounting statements to be consistent with statutory accounting language in each respective statement.

Bonds, Excluding Loan-Backed and Structured Securities

4. The guidance in paragraphs 5 and 6 of this statement shall supersede the guidance in paragraph 9 of SSAP No. 26.

Impairment

5. An other-than-temporary 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 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. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bonds carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. Credit related other-than-temporary impairment losses shall be recorded through the AVR; interest related other-than-temporary impairment losses shall be recorded through the IMR.

6. In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.
Preferred Stock

7. The guidance in paragraphs 8 through 11 of this statement shall supersede the guidance in paragraphs 22 through 24 of SSAP No. 32.

Impairment of Redeemable Preferred Stock

8. An other-than-temporary 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 the security in effect at the date of acquisition. A decline in fair value which is other-than-temporary includes situations where the 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). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock’s carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.

9. In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 18 or paragraph 20 of SSAP No. 32, as applicable. The fair value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Impairment of Perpetual Preferred Stock

10. If it is determined that a decline in the fair value of a perpetual preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock’s carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.

11. In periods subsequent to the recognition of an other-than-temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 19 or paragraph 21 of SSAP No. 32, as applicable. The fair value of the perpetual preferred stock on the measurement date shall become the new cost basis of the perpetual preferred stock and the new cost basis shall not be adjusted 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.

Investment Income Due and Accrued

12. The guidance in SSAP No. 34, paragraph 3, shall be modified by this statement as follows:
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.) Immediate amortization of premium which occurs upon recognition of an other-than-temporary impairment loss for a debt security with a recorded premium shall be reported as a realized loss and shall not be included in investment income.

**Loan-Backed and Structured Securities**

13. This statement shall insert the following new paragraph 17 into SSAP No. 43, with subsequent paragraphs of SSAP No. 43 to be renumbered accordingly:

   17. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. 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 impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

**Disclosures**

14. This statement requires no additional disclosures.

**Relevant Literature**

15. This statement adopts FSP FAS 115-1/124-1, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

**Effective Date and Transition**

16. This statement is effective for reporting periods beginning on January 1, 2009 and thereafter, with early adoption permitted.

**AUTHORITATIVE LITERATURE**

**Generally Accepted Accounting Principles**

- FASB Staff Position No. FAS 115-1/124-1, *The Meaning of Other-Than- Temporary Impairment and Its Application to Certain Investments*

**RELEVANT ISSUE PAPERS**

- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than- Temporary Impairment*
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## Nullified Interpretations

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Interpretation of the Emerging Accounting Issues Working Group

INT 99-02: Accounting for Collateral in Excess of Debt Principal

ISSUE NULLIFIED BY SSAP No. 91R

INT 99-02 Date Discussed

December 7, 1998; March 8, 1999

INT 99-02 References

SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
(SSAP No. 18)

INT 99-02 Issue

1. Insurers who borrow from Federal Home Loan Banks (“FHLB”) are required to pledge assets in excess of the principal amounts they borrow (while this issue emanates from reviewing a FHLB loan to an insurer, the same issue arises with regard to an over-collateralized loan to any reporting entity). Insurers must deposit assets pledged to secure FHLB loans with the lending FHLB, and do not have the ability to withdraw the requisite excess collateral unless the loan is repaid.

2. If an insurer (reporting entity) is required to secure a borrowing with assets/collateral in excess of the principal amount of the loan received, should that excess collateral be considered a non-admitted asset?

3. There does not appear to be any guidance on this issue in the current Accounting Practice and Procedure Manual. SSAP No. 18, paragraph 10 provides guidance on accounting for collateralized loans, but does not address excess collateralization.

INT 99-02 Discussion

4. The working group was unable to reach a consensus as to either to disclose the excess collateral in the notes to the financial statements or nonadmit the asset.

INT 99-02 Status

5. As the working group was unable to reach a consensus, this issue will be referred to the Accounting Practices and Procedures (E) Task Force for appointment to the Codification of Statutory Accounting Principles Working Group and further discussion.
Interpretation of the Emerging Accounting Issues Working Group

INT 99-03: Accounting for Investment in Subsidiary, Controlled or Affiliated (SCA) Entities with Subsequent Downstream Investment in an Insurance Company

ISSUE NULLIFIED BY SSAP No. 88

INT 99-03 Dates Discussed
December 7, 1998; March 8, 1999

INT 99-03 References
SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46)

INT 99-03 Issue
1. SSAP No. 46 defines the accounting for investments in SCAs by classifying them into three broad categories; 1) insurance SCAs, 2) 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 3) 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. If the equity method of accounting is used, category (1) and (2) SCAs receive statutory equity accounting whereas category (3) SCAs receive audited GAAP equity accounting. An investment in an entity that in turn owns one or more insurance companies and noninsurance company’s meets the definition of outlined in both category (1) and (3) SCAs.

2. Is an investment in an entity that in turn owns one or more insurance companies and noninsurance companies meet the definition of an insurance SCA or a noninsurance SCA 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?

INT 99-03 Discussion
3. The working group reached a consensus to clarify that the definition of an insurance SCA would apply to any entity that included an insurance company with its reporting or holding company structure.

INT 99-03 Status
4. No further discussion is planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments

ISSUE NULLIFIED BY SSAP No. 95

INT 99-21 Date Discussed
June 7, 1999; October 4, 1999

INT 99-21 References
SSAP No. 18—Accounting For Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18)
SSAP No. 28—Nonmonetary Transactions (SSAP No. 28)
SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R)

INT 99-21 Issue

1. For GAAP purposes, accounting for the exchange of nonmonetary assets is addressed in APB Opinion No. 29, Accounting for Nonmonetary Transactions (APB No. 29), and allows in some cases, such as an equity method investment, an exchange to be based upon its historical cost. For statutory purposes, APB No. 29 was adopted without modification in SSAP No. 28. FASB Statement No. 125, Accounting For Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125), provides that transfers of financial assets should be recorded at their fair market values. This concept was also adopted for statutory purposes in SSAP No. 91R. EITF 98-7, Accounting for Exchanges of Similar Equity Method Investments (EITF 98-7), clarifies the inconsistency between these two GAAP pronouncements as they relate to the exchange of equity method investments.

INT 99-21 Discussion

2. The working group reached a consensus that EITF 98-7 be adopted to provide that the exchange of equity method investments to be accounted for at historical cost, and not fair market value.

INT 99-21 Status

3. No further discussion is planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 99-24: Accounting for Restructuring Charges

ISSUE NULLIFIED BY SSAP No. 89

INT 99-24 Dates Discussed

October 4, 1999; December 6, 1999

INT 99-24 References

SSAP No. 8—Pensions (SSAP No. 8)

INT 99-24 Issue

1. Reporting entities may make a strategic decision to downsize their operations. In doing so, these entities often offer severance pay and other benefits to displaced workers, cancel leases early, etc. These costs are estimated at the time of restructuring and on a GAAP basis are booked to the financial statements. It has been noted that companies handle these costs in at least two different ways. In one case, the reporting entity recorded these restructuring costs as an aggregate write-in for gains and losses in surplus. In another case, the company was allocated the cost by its parent, and appropriately accounted for these costs in accordance with SSAP No. 15—Debt and Holding Company Obligations.

2. Should costs associated with downsizing be recorded as an expense in the reporting entity’s financial statements, or should they be recorded as an adjustment of unassigned funds (surplus)?

INT 99-24 Discussion

3. The working group reached a consensus to record costs associated with downsizing as an expense in the financial statements.

INT 99-24 Status

4. No further discussion is planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 99-28: Accounting for SCA Mutual Funds, Broker-Dealers and Similar Entities Under SSAP No. 46

ISSUE NULLIFIED BY SSAP No. 88

INT 99-28 Dates Discussed

October 4, 1999; December 6, 1999

INT 99-28 References

SSAP No. 46—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 46)

INT 99-28 Issue

1. SSAP No. 46 paragraphs 7.b.ii. and 7.b.iii. identify two equity methods of accounting – statutory and GAAP, respectively – to be used to account for noninsurance subsidiary, controlled or affiliated entities. The selection of a method depends upon whether the noninsurance SCA holds assets primarily for the direct or indirect benefit of the insurer or the noninsurance SCA has significant business operations beyond the holding of assets for the insurer. However, SSAP No. 46 also contains, in paragraph 8, an additional reference relative to whether or not primary operations of the SCA are provided or not provided to the insurance industry.

2. Should paragraph 7.b.ii. or paragraph 7.b.iii. apply to SCA mutual funds, broker-dealers or similar entities? The activities of these entities are investment operations and consequently, they engage in trading activities. Such entities are also highly likely to have third-party customers other than the owner/insurer; therefore, they have significant ongoing operations beyond holding assets for the primary benefit of the insurer. In addition, mutual funds, broker-dealers and similar organizations have their own specialized GAAP accounting, suited to their trading purposes.

INT 99-28 Discussion

3. The working group reached a consensus that SCA mutual funds and broker-dealers that are registered with the Securities and Exchange Commission, and have significant ongoing operations other than holding assets for the reporting entity, follow the valuation guidance outlined in paragraph 7.b.iii. of SSAP No. 46. That is, those entities should be valued using the audited GAAP equity method.

INT 99-28 Status

4. No further discussion is planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 00-01: Investment in Foreign SCA Entity

ISSUE NULLIFIED BY SSAP No. 88

INT 00-01 Dates Discussed

October 4, 1999; December 6, 1999

INT 00-01 References

SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated (SCA) Entities (SSAP No. 46)

INT 00-01 Issue

1. SSAP No. 46 defines the accounting for investments in SCA entities. The following guidance is included in paragraph 7 of SSAP No. 46:

   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 SSAP No. 68—Business Combinations and Goodwill (SSAP 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 SSAP No. 68. Examples include but are not limited to: (i) an insurer and a SCA entity that leases autos, furniture, office equipment, or computer equipment to the insurer, (ii) an insurer and a SCA entity that owns real estate property that is leased to the insurer for office space, and (iii) 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: (i) a property-casualty or life insurer and a SCA entity that is an oil and gas venture, and (ii) a property-casualty insurer or life insurer and a SCA manufacturer.

2. If a reporting entity has an interest in a foreign company (defined in this context as a company located outside the United States), does the reporting entity use the foreign basis of
accounting or the United States (U.S.) basis of accounting? For instance, if a reporting entity is domiciled in South Carolina and they own an insurance company located in Germany, does the company book the statutory equity as defined by German accounting or do they convert the financials to the statutory accounting prescribed or permitted in South Carolina? This scenario is also applicable to 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. Does the reporting entity use German GAAP or U.S. GAAP?

**INT 00-01 Discussion**

3. The working group reached a consensus that entities shall follow the guidance outlined in the *Purposes and Procedures Manual of the Securities Valuation Office* Part 8, Section 3(g) for investments in foreign SCA entities defined in SSAP No. 46 paragraph 7.b.i. and 7.b.ii. For investments in foreign SCA entities defined in SSAP No. 46 paragraph 7.b.iii., entities shall use audited U.S. GAAP as the basis for valuation.

**Part 8 - Section 3**

(a) Admitted Asset Equivalent

Pursuant to this method, which may only be used for non-insurance SCA companies, the value of the common stock is limited to the value of those assets of the SCA company that would constitute lawful investments for the insurance company, if acquired or held directly by the insurance company. This is the sole valuation method that permits submission and use of an unaudited financial statement.

(g) Foreign Subsidiary

Pursuant to this provision, insurance companies may apply the Admitted Asset Equivalent method discussed in Section 3 (a) above to insurance companies organized in foreign countries. The basis for the calculation of value will be the financial statements of that insurance company for the most recent fiscal year, prepared by a certified public accountant.

**INT 00-01 Status**

4. No further discussion is planned.
INterpretation of the Emerging Accounting Issues Working Group

INT 00-21: Disclose Requirement of SSAP No. 10 Paragraphs 17 & 18

ISSUE NULLIFIED BY SSAP 10 QUESTION AND ANSWER IMPLEMENTATION GUIDE WHICH CAN BE FOUND AS EXHIBIT A TO SSAP 10.

INT 00-21 Dates Discussed

June 12, 2000; September 11, 2000

INT 00-21 References

SSAP No. 10—Income Taxes

INT 00-21 Issue

1. The following guidance is included in paragraphs 17 and 18 of SSAP No. 10 (SSAP No. 10):

   17. Statutory financial statement disclosure shall be made in a manner consistent with the provisions of paragraphs 43 – 45 and 48 of FASB Statement No. 109, Accounting for Income Taxes (FAS 109). However, required disclosures with regard to a reporting entity's valuation allowance shall be replaced with disclosures relating to the nonadmittance of some portion or all of a reporting entity's DTAs. The financial statements shall include the disclosures required by paragraph 47 of FAS 109 for nonpublic companies. Paragraphs 18 to 23 describe the disclosure requirements as modified for the difference between the requirements of FAS 109 and those prescribed by this statement.

   18. The components of the net DTA or DTL recognized in a reporting entity’s balance sheet shall be disclosed as follows:

      a. The total of all DTAs (admitted and nonadmitted);
      b. The total of all DTLs;
      c. The total DTAs nonadmitted as the result of the application of paragraph 10; and
      d. The net change during the year in the total DTAs nonadmitted.

2. Paragraph 17 indicates that paragraph 43 of FAS 109 is adopted but is silent as to the issue of a public or nonpublic enterprise. Paragraph 43 of FAS 109 reads as follows:

   43. The components of the net deferred tax liability or asset recognized in an enterprise's statement of financial position shall be disclosed as follows:

      a. The total of all deferred tax liabilities measured in procedure (b) of paragraph 17
      b. The total of all deferred tax assets measured in procedures (c) and (d) of paragraph 17
      c. The total valuation allowance recognized for deferred tax assets determined in procedure (e) of paragraph 17.
The net change during the year in the total valuation allowance also shall be disclosed. A **public enterprise** shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances). A **nonpublic enterprise** shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type. A public enterprise that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the enterprise's assets and liabilities.

3. The issues are:
   a. Should entities use their own judgement to determine whether they are a public or nonpublic enterprises as those terms are not defined in the SSAP?
   b. As noted in paragraph 17 of SSAP No. 10, there is a specific reference to require the nonpublic disclosure of paragraph 47 of FAS 109; therefore should there be specific guidance for paragraph 43?

**INT 00-21 Discussion**

4. The working group reached a consensus to adopt a requirement that all entities complete the provisions of SSAP No. 10 paragraph 18 following the public enterprises guidelines outlined in paragraph 43 of FAS 109. The rationale for the recommendation is that it is important for analysts to see this level of detail every year rather than every three years when an examination is completed. In addition, as the concept of deferred income taxes is new to the regulators, the working group feels that additional disclosure is appropriate.

**INT 00-21 Status**

5. No further discussion is planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 00-22: Application of SSAP No. 10 to Admissibility of Deferred Tax Assets

ISSUE NULLIFIED BY SSAP NO. 10 QUESTION AND ANSWER IMPLEMENTATION GUIDE WHICH CAN BE FOUND AS EXHIBIT A TO SSAP NO. 10.

INT 00-22 Date Discussed

June 12, 2000; September 11, 2000

INT 00-22 References

SSAP No. 10—Income Taxes (SSAP No. 10)

INT 00-22 Issue

1. SSAP No. 10, paragraph 10.a., provides that a reporting entity may admit deferred tax assets (DTAs) in an amount equal to federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year. The NAIC staff have received several inquiries as to the practical application of this admissibility guidance.

2. The primary question that arises is whether or not the reporting entity is required to project a tax net operating loss (NOL) for future periods before admitting any DTAs in accordance with paragraph 10.a. Interpreted literally, it appears the reporting entity is required to estimate a tax NOL for the subsequent tax year. However, the following practical application concerns arise when estimating a tax NOL:

   a. An entity may not be able to estimate their tax NOL or tax obligation for the subsequent tax year. While taxable entities currently estimate their tax on a quarterly basis to ensure proper quarterly tax payments are made to the Internal Revenue Service, the entity may not be able to reasonably estimate the annual tax.

   b. An entity will be able to admit the same amount of DTA for loss carrybacks pursuant to paragraph 10.b.i. of SSAP No. 10, provided the entity is not limited to the ten percent of statutory capital and surplus described in paragraph 10.b.ii.

   c. It is uncertain whether or not the benefit of estimating a tax NOL for the subsequent tax year will exceed the costs involved (i.e., subjectivity in estimates) in performing the estimation.

INT 00-22 Discussion

3. The working group reached a consensus that paragraph 10.a. of SSAP No. 10 does not require a reporting entity to project a tax NOL for future periods. Rather, the reporting entity may admit DTAs equal to the amount of taxes paid in prior years (the tax years before the NOL year) that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year, regardless of whether or not the reporting entity anticipates a tax NOL in the following tax year. Generally, the reporting entity must carry back the entire amount of the NOL to the applicable tax years before the NOL year (the carryback
period), and then carry forward any remaining NOL (the carryforward period). The reporting entity can, however, choose not to carry back an NOL and carry it forward only. The NOL year is the year in which the NOL occurred. The reporting entity cannot deduct any part of the NOL remaining after the carryforward period. This interpretation is illustrated as follows:

Assumptions:

(1) ABC Company paid Year 2001 taxes in the amount of $300,000. The entire $300,000 may be carried back pursuant to the two year carryback period provided by the current IRS provisions. Year 2001 was the first year in which the company paid income taxes. The company does not expect to generate a tax NOL in 2002.

(2) ABC Company has $10,000,000 of gross DTAs at 12/31/01, $2,000,000 of which is expected to reverse by 12/31/02. The $2,000,000 is significantly less than 10% of the company’s adjusted capital and surplus.

(3) ABC Company has $8,000,000 of gross deferred tax liabilities (DTLs) at 12/31/01.

ABC Company will admit the following DTAs at 12/31/01 pursuant to SSAP No. 10:

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<th>Paragraph</th>
<th>Amount</th>
<th>Description</th>
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<td>10.a</td>
<td>$300,000</td>
<td>(Taxes paid in prior year which are eligible for NOL carryback.)</td>
</tr>
<tr>
<td>10.b</td>
<td>1,700,000</td>
<td>($2,000,000 worth of DTAs reversing in 2002 less $300,000 from paragraph 10.a.)</td>
</tr>
<tr>
<td>10.c</td>
<td>8,000,000</td>
<td>(Amount of DTAs offset against existing DTLs.)</td>
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<tr>
<td>Total</td>
<td>$10,000,000</td>
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INT 00-22 Status

4. No further discussion
Interpretation of the Emerging Accounting Issues Working Group

INT 00-23: Reinsurance of Deposit Type Contracts

ISSUE NULLIFIED BY SSAP NO. 61

INT 00-23 Dates Discussed

June 12, 2000; September 11, 2000

INT 00-23 References

Appendix A-791, Life and Health Reinsurance Agreements (A-791)
Appendix A-785, Credit for Reinsurance (A-785)
SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force (SSAP No. 50)
SSAP No. 52—Deposit-Type Contracts (SSAP No. 52)
SSAP No. 61—Life, Deposit-Type and Accident and Health Reinsurance (SSAP No. 61)

INT 00-23 Issue

1. In the situation under consideration, an insurer issues a guaranteed interest contract or funding agreement to an institutional customer that provides for the accumulation of a deposit at a fixed or variable interest rate. The contract either has a specific maturity date or it has a notice period for withdrawal (for example 180 days) in lieu of a specific maturity date. Depending on the customer, the contract may provide for interim contract withdrawals for interest accumulated, for specific events (such as 401K plan benefit payments), or for any event with certain notice periods. The contracts may or may not have a market value adjustment or surrender charge for certain types of early withdrawals.

2. These contracts sold to institutions may or may not include life contingent purchase rate guarantees for annuitization. It depends upon the state in which the contract form is filed and the domiciliary state of the issuer as to whether that language is required for form approval. If the language is included in the form, there is no annuitant listed on the schedule page, but one could be announced by the policyholder at a later date. It is not the intention of the policyholder or the expectation of the issuer that annuities will be purchased to settle the terms of the contract. Instead, it is always expected to be settled in cash at the withdrawal date.

3. For this situation, the state in which the contract form is filed does not require language for life contingent purchase rate guarantees for annuitization to be included in the contract, so it is not in the contract.

4. The liability under this contract is ceded from the insurer to an affiliated insurance entity under a 100% coinsurance agreement that meets the transfer of appropriate economic risks under A-791 for guaranteed interest contracts of credit risk, reinvestment risk and disintermediation risk. In addition, the reinsurance contract meets the other accounting requirements listed in A-791.

5. The assuming insurer is licensed to transact insurance or reinsurance or is accredited as a reinsurer in the domiciliary state of the ceding insurer, so it meets the criteria to receive reinsurance credit under A-785.
6. The accounting issue is how to account for the liability that has been ceded on the issuer’s balance sheet when the contract does not contain life contingent purchase rate guarantees for annuitization.

7. There is conflicting reporting guidance promulgated between SSAP No. 52, paragraph 10, which allows the deduction to be made from the policy or claim reserves of the ceding insurer for the amount ceded and SSAP No. 61, paragraph 51, which does not allow the deduction to be made from the policy or claim reserves of the ceding insurer and instead requires a receivable to be established by the ceding insurer.

8. SSAP No. 50 paragraphs 43, 44 and 45, indicate that contracts that do not incorporate insurance risk (i.e., do not have any life or disability contingencies) should be accounted for as deposit-type contracts. SSAP No. 52 paragraph 2 further defines insurance risk “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 specified individual or group of individuals.” Based on this definition, it appears the contract described above meets the definition of a deposit type contract and should be accounted for in accordance with SSAP No. 52.

9. SSAP No. 52, paragraph 10 indicates that “Policy reserves shall be increased for reinsurance assumed and decreased for reinsurance ceded as further described in SSAP No. 61.” This reference would lead a knowledgeable reader to come to the reasonable conclusion that the ceding insurer would decrease its reserve liability held for the ceded contracts by the amount ceded to the reinsurer.

10. However, there is conflicting language in SSAP No. 61 as it relates to SSAP No. 52, paragraph 10. SSAP No. 61, paragraph 18 indicates “All reinsurance agreements covering insurance products that transfer significant mortality or morbidity risk shall follow the guidance for reinsurance accounting contained in this statement. All reinsurance contracts covering insurance products that do not provide for sufficient transfer significant mortality or morbidity of risk, or covering deposit-type contracts as defined in SSAP No. 52 shall follow the guidance contained in SSAP No. 61 paragraph 51 for Deposit Accounting.”

11. SSAP No. 61 paragraph 51 states “To the extent that a reinsurance contract does not, despite its form, provide for sufficient transfer of risk, or reinsures deposit-type contracts, amounts exchanged between the parties are to be accounted for and reported as follows:

   a. At the outset of the reinsurance contract, the net consideration exchanged between the parties shall be recorded as an asset by the payer of the net considerations and as a liability by the receiver. The amount to be admitted as an asset is subject to the limitations for transactions with unauthorized reinsurers described in Appendix A-785. Throughout the life of the contract, receipts and disbursements shall be recorded through the asset/liability accounts. Income and losses shall be recognized by a party when, according to the terms of the contract, it has earned the amount and the other party has no recourse to repayment of such amount in future periods. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other miscellaneous insurance income or miscellaneous insurance loss;” At the outset of the reinsurance contract, the net consideration exchanged between the parties shall be recorded as an asset by the payer for the net considerations and as a liability by the receiver.”
12. It further goes on in paragraph 51b. to state: “No deduction shall be made from the policy or claim reserves on the balance sheet, schedules and exhibits.”

**INT 00-23 Discussion**

13. The working group reached a consensus to allow a ceding insurer to reduce deposit-type contract reserves for the amount ceded, provided the criteria in Appendices A-785 and A-791 are met.

**INT 00-23 Status**

14. No further discussion is planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 01-04: SSAP Nos. 18 and 33 and Issues Surrounding Securitizations

ISSUE NULLIFIED BY SSAP No. 91R

INT 01-04 Dates Discussed

December 4, 2000; March 26, 2001

INT 01-04 References

SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
(SSID No. 18)
SSAP No. 33—Securitizations (SSAP No. 33)

INT 01-04 Issue

1. Paragraph 5b. of SSAP No. 33 is more limiting than Paragraph 3b. of SSAP No. 18 and paragraph 9b of SFAS 125—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125).

2. Paragraph 3b. of SSAP No. 18 states the following:

3. Except as discussed in paragraph 35, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

   b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraph 14), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 9 of SSAP No. 33 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 14), to pledge or exchange those interests; and

3. Paragraph 5b. of SSAP No. 33 states the following:

5. The transferor has surrendered control if, and only if, all of the following conditions are met:

   b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests; and

4. Paragraph 9 of SSAP No. 33 states the following:

9. A qualifying special-purpose entity (including a CMO special-purpose entity) as used in this statement must meet all of the following conditions:
a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
   i. Holding title to transferred financial assets;
   ii. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.);
   iii. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held; and
   iv. Distributing proceeds to the holders of its beneficial interests.

b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

5. Paragraph 9b. of FAS 125 states the following:

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:

   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.

6. The accounting issue is if a reporting entity transfers assets to an entity that does not meet the definition of a qualified special-purpose entity as described in paragraph 9 of SSAP No. 33, but does meet the requirements for surrender of control under paragraph 3b. (i) of SSAP No. 18, would the transaction be accounted for as a sale?

INT 01-04 Discussion

7. The working group reached a consensus that if the transaction meets the criteria outlined in SSAP No. 18, then the transaction would be accounted for as a sale.

INT 01-04 Status

8. No further discussion planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 01-17: Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans

ISSUE NULLIFIED BY SSAP No. 89

INT 01-17 Dates Discussed

March 26, 2001; June 11, 2001

INT 01-17 References

SSAP No. 8—Pensions (SSAP No. 8)

INT 01-17 Issue

1. Calculations of the Projected Benefit Obligation (PBO) and Service Cost (SC) under SSAP No. 8 are identical to calculations under the FASB Statement No. 87, Employers’ Accounting for Pensions (FAS 87), except for the treatment of nonvested benefits. Under FAS 87, a participant’s status as pre- or post-vested in benefits receives no differential treatment. SSAP No. 8 contains clauses that indicate nonvested benefits are to be ignored until the employee becomes eligible and vested.

2. A defined benefit plan covered by ERISA is a type of deferred compensation arrangement. A plan’s primary purpose must be to provide replacement income to a participant following retirement. The benefits that are to be received may or may not become vested (although this term is often used, the legal term is “nonforfeitable”) prior to actual retirement. A plan is only required to provide nonforfeitability provisions if the plan seeks qualification under the Internal Revenue Code. On the other hand, in order to remain nonqualified, the plan may only cover a select group of highly compensated employees. In substance, nonqualified plans are identical to deferred compensation plans, where the only difference may be that a nonqualified plan is provided solely at the discretion of the employer and whether or not to participate in a deferred compensation plan may be predicated on a decision of the employee. Both qualified and nonqualified plans are nearly universal throughout the insurance industry.

3. A more narrowly defined term in qualified plans is “protected” benefits under Internal Revenue Code Section 411(d)(6). These are the benefits that the employer cannot take away through amendment (including termination) of the plan. Examples of protected benefits are alternative forms of payment, retirement-type subsidies (e.g., early retirement benefits) and qualified pre-retirement joint and survivor benefits (this is the only ancillary benefit that is protected). Protected benefits need not be nonforfeitable. For example, an early retirement subsidy applicable to a currently accrued benefit cannot be taken away through an amendment to the plan. However, the participant may lose their right to collect the subsidy if they terminate prior to becoming eligible to receive it.

4. Example: Assume a plan has a subsidized early retirement benefit (defined benefit plans almost universally do) that is only payable if retirement occurs directly from active employment. The PBO under FAS 87 for a participant is $200,000, where $50,000 of this is due to the subsidized early retirement benefit. i.e., if we assume the person retires at normal retirement, the PBO would only be $150,000. It is not clear whether the PBO should be $150,000 or $200,000 under SSAP No. 8. The $50,000 is not a nonforfeitable benefit, i.e., if the person terminates prior
to becoming eligible for the early retirement benefit, they only receive a benefit worth $150,000. However, the $50,000 is a protected benefit that cannot be taken away through a plan amendment. As long as the participant remains in active employment and eventually become eligible, they will have a right to receive this benefit. For a second example, assume the subsidized early retirement benefit in the prior example is available no matter when the participant terminated employment. (The common 1/15th, 1/30th reduction used in integrated plans is a subsidized early retirement benefit that is typically available to previously terminated participants.) In this case, the early retirement subsidy is nonforfeitable and the entire $200,000 would be the PBO under SSAP No. 8.

5. In addition to replacement income at retirement, retirement plans contain a variety of ancillary benefits, most of which are not nonforfeitable. For example, all death and disability benefits except for the qualified pre-retirement joint and survivor benefit might only become nonforfeitable once the triggering event (death or disability) occurs. Some plans do provide nonforfeitability provisions to these ancillary benefits, but that is rare. The easiest test as to whether an ancillary benefit is nonforfeitable is whether or not the participant still receives that benefit when the triggering event happens after termination of employment. The qualified pre-retirement joint and survivor death benefit is one such benefit that is still available after termination of employment. Nearly all defined benefit plans contain ancillary benefits that do not become nonforfeitable.

6. Nonqualified plans typically do not have nonforfeitability provisions connected with any benefit, including the main retirement benefit. The reason for this is the application of the constructive receipt standard under the Internal Revenue Code. Under this standard, there must be a “substantial risk of forfeiture” in order to avoid constructive receipt. At the point when the benefits lose this substantial risk of forfeiture, i.e., become nonforfeitable, the value of the benefits becomes taxable income to the participant even though no benefits have been paid. Therefore, most nonqualified plans do not contain provisions for nonforfeitability, i.e., the benefits never vest prior to payment. Typically, the only situation where there is nonforfeitability is when a “secular trust” is used to fund the benefits. These trusts are owned by the participant and income taxes must be paid on employer’s contributions to the trust and the earnings thereon. A similar type of trust which is used more often to fund nonqualified benefits is a “rabbi trust.” These do not invoke such taxation because they are available to creditors (and policyholders) in the event of bankruptcy (or insolvency), which is a sufficient condition to invoke a “substantial risk of forfeiture.”

7. Another aspect of nonforfeitability that is often overlooked is that it only applies to living participants. If a participant dies, they may not have any benefits due to them. For example, assume a plan does not contain any ancillary death benefits other than the required qualified pre-retirement joint and survivor benefit. If a single participant dies prior to retirement, the estate will receive nothing from the plan. In accounting terms, assume the PBO associated with this person is $500,000. This represents the present value of the projected retirement benefit accrued to date. Within that present value calculation are assumptions discounting the value for the probability of not receiving anything upon death. If the participant dies, the PBO reverts to zero and there is a $500,000 unrecognized gain that is amortized. Even though the participant was 100% vested in a retirement benefit worth $500,000, there is no guarantee that the plan is responsible to pay it, unless the participant lives to receive it.

8. As a separate example, assume the same facts except that the plan contains an ancillary death benefit equal to the present value of the retirement benefit, not discounted for pre-retirement mortality. Assume the amount paid out upon death is $600,000 and the PBO associated with the value of this death benefit is $100,000. The aggregate PBO under FAS 87 would be $600,000. Whether the participant lives until retirement or dies prior to retirement, a benefit will
be paid out in the future that is worth $600,000 today as long as the participant remains employed. Under SSAP No. 8, only $500,000 would be valued in the PBO because the death benefit is not a nonforfeitable benefit.

9. For married participants, the same loss of benefits can occur upon death, except that there is a minimum death benefit equal to the qualified pre-retirement joint and survivor annuity. This death benefit may only be worth 40-45% of the retirement benefit. So, in the case of a plan that contains a death benefit described in the second example above, part of the extra $100,000 (e.g., 45% of it) is a nonforfeitable benefit for married participants, whereas the remaining part is not nonforfeitable, similar to the single participant’s situation.

10. Summarizing, there are many aspects of vesting beyond a vesting schedule applied to the normal retirement benefit. Also, most nonqualified plans never have any vesting applied. In addition, there are benefits associated with retirement benefits that are protected, but not vested (i.e., if the participant stays in employment until eligible, they have the right to receive them, but if they terminate sooner, they may lose those rights).

11. Returning to SSAP No. 8, the following are the references to vesting:

   Paragraph 2: "...with a modification to exclude nonvested employees. Therefore, the cost related to services rendered prior to becoming eligible and vested in the plan..."

12. This could be referring to both nonvested retirement benefits and to ancillary benefits. However, the confusion here is the use of the term “nonvested employees” rather than “nonvested benefits”. An employee can be vested in one benefit while not vested in another. The protected benefits that are not nonforfeitable (e.g., subsidized early retirement benefits) may also be included in this statement because of the reference to “becoming eligible”.

   Paragraph 15(a): "Calculation of the pension obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts;"

13. Again, the confusing aspect of this is the reference to employees, rather than benefits. In this case, the statement “...extent of their vested amounts;” could mean that ancillary benefits are amounts that would not be included. After all, every participant is a “partially vested employee” when all benefits are considered.

14. The accounting issue is when applying SSAP No. 8 to calculations for the accounting of defined benefit plans:

   Issue 1 - Should nonvested, ancillary benefits (primarily death and disability benefits) be ignored in the PBO and SC prior to the triggering event (e.g., death or disability) of these benefits?

   Issue 2 - Should protected, nonvested benefits (e.g., retirement-type subsidies such as early retirement benefits) be ignored in the PBO and SC prior to becoming eligible for these benefits?

   Issue 3 - Should nonvested, nonqualified benefits be ignored prior to retirement or when there is no longer a substantial risk of forfeiture?

**INT 01-17 Discussion**

15. The working group reached the following consensus’s on the three issues raised:
Issue 1 - Should nonvested, ancillary benefits (primarily death and disability benefits) be ignored in the PBO and SC prior to the triggering event (e.g., death or disability) of these benefits?

The working group reached a consensus that nonvested, ancillary benefits should not be ignored in the PBO and SC prior to the triggering event of these benefits. A liability for these benefits should be accrued in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard).

Issue 2 - Should protected, nonvested benefits (e.g., retirement-type subsidies such as early retirement benefits) be ignored in the PBO and SC prior to becoming eligible for these benefits?

The working group reached a consensus that protected, nonvested benefits should not be ignored in the PBO and SC prior to the employee becoming eligible for these benefits. A liability for these benefits should be accrued in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard).

Issue 3 - Should nonvested, nonqualified benefits be ignored prior to retirement or when there is no longer a substantial risk of forfeiture?

The working group reached a consensus that nonvested, nonqualified benefits should not be ignored in the PBO and SC prior to retirement or when there is no longer a substantial risk of forfeiture. A liability for these benefits should be accrued in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard).

INT 01-17 Status

16. No further discussion planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 01-19: Measurement of Deferred Tax Assets Associated with Nonadmitted Assets

ISSUE NULLIFIED BY SSAP NO. 10 QUESTION AND ANSWER IMPLEMENTATION GUIDE, WHICH IS EXHIBIT A TO SSAP NO. 10.

INT 01-19 Dates Discussed

March 26, 2001; June 11, 2001

INT 01-19 References

SSAP No. 10—Income Taxes (SSAP No. 10)

INT 01-19 Issue

1. An entity may have certain assets, such as property and equipment and prepaid commissions, which are nonadmitted assets for statutory reporting purposes, but have a tax basis that is expected to result in future tax deductions.

2. The accounting issue is how should an entity measure the deferred taxes for the future tax effects associated with nonadmitted assets?

3. For example, assume the following information:

An entity has Furniture, Fixtures and Equipment (FFE) with an original cost of $1,000, accumulated depreciation for book purposes of $200, and accumulated depreciation for tax purposes of $400. Statutory surplus is $10,000. Also assume an effective tax rate of 35%.

**Alternative I – Measure DTAs/(DTLs) before nonadmitted assets:**

<table>
<thead>
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<th></th>
<th>Statutory Before Nonadmitted</th>
<th>Tax Difference</th>
<th>DTA (DTLs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original cost</td>
<td>$1,000</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>200</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>Basis</td>
<td>$ 800</td>
<td>$ 600</td>
<td>$200 (70)</td>
</tr>
</tbody>
</table>

The effect of Alternative I is to reduce statutory surplus by $870. That is, $800 for FFE and $70 for the deferred tax liability as a result of calculating deferred taxes prior to nonadmitted assets.
**Alternative II – Measure DTAs/(DTLs) after nonadmitted assets:**

<table>
<thead>
<tr>
<th>Statutory After Nonadmitted</th>
<th>Tax</th>
<th>Difference (DTLs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original cost</td>
<td>$  -0-</td>
<td>$1,000</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>-0-</td>
<td>400</td>
</tr>
<tr>
<td>Basis</td>
<td>$  -0-</td>
<td>$   600</td>
</tr>
</tbody>
</table>

The effect of Alternative II is to reduce surplus by $590 ($800 decrease for nonadmitted asset and $210 increase for DTA), provided the resulting DTA meets the admissibility test in paragraph 10 of SSAP No. 10.

**INT 01-19 Discussion**

4. The working group reached a consensus that a reporting entity’s balance sheet shall include DTAs resulting from the expected future tax consequences of temporary differences generated by statutory accounting practices, as defined in paragraph 11 of FASB Statement No. 109, *Accounting for Income Taxes*. DTAs are computed using a “balance sheet” approach whereby differences between statutory and tax basis balance sheets are treated as temporary differences. Nonadmitted assets with a tax basis create temporary differences as discussed in paragraph 6b. of SSAP No. 10. The future tax benefits associated with nonadmitted assets embody the three characteristics of an asset as described in FASB Concepts Statement 6. That is, 1) they represent future economic benefit that contribute to future economic cash flow; 2) the enterprise can obtain and control others’ access to it; and 3) the transaction or event giving rise to the entity’s right to control it has occurred. These characteristics are the characteristics of assets as also reflected in *SSAP No. 4—Assets and Nonadmitted Assets*. Accordingly, a DTA for a nonadmitted asset should be calculated under the “balance sheet” approach, Alternative II, using enacted rates applied to the difference between the statutory basis after the asset is nonadmitted and the tax basis of that asset. The resulting DTA is then subject to the admissibility tests included in SSAP No. 10.

**INT 01-19 Status**

5. No further discussion planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 01-20: Utilization of Tax Planning Strategies for the Admissibility of Deferred Tax Assets

ISSUE NULLIFIED BY SSAP NO. 10 QUESTION AND ANSWER IMPLEMENTATION GUIDE, WHICH IS EXHIBIT A TO SSAP 10.

INT 01-20 Dates Discussed
March 26, 2001; June 11, 2001

INT 01-20 References
SSAP No. 10—Income Taxes (SSAP No. 10)

INT 01-20 Issue

1. An entity may have available certain actions or tax planning strategies that are prudent and feasible. However, the entity ordinarily might not take such actions, but for the expiration of an unused operating loss or other tax credit carryforward or for other valid reasons. In all cases the implementation of these strategies are entirely within the control of the entity. The tax planning strategy, if implemented, is expected to result in realization of deferred tax assets (DTAs) within one year of the balance sheet date. Accordingly, the DTAs are recoverable or realizable within one year of the balance sheet date, but the entity, in some circumstances, may not choose to take the action(s) necessary to realize the DTAs within that one year period. Absent the expiration of a carryforward, the strategy can be implemented in a subsequent year.

2. The accounting issues is whether an entity is expected to implement a tax planning strategy within one year of the balance sheet date in order to support the realizability of a tax asset within one year of the balance sheet date?

INT 01-20 Discussion

3. The working group reached a consensus that an entity needs to demonstrate that it has a prudent and feasible tax planning strategy available that, if implemented, would result in realization of deferred tax assets (DTAs) within one year of the balance sheet date. The entity must also have the intent to implement such strategy. In such circumstances an entity may recognize as admitted assets, the related DTAs that are recoverable as a result of the available tax planning strategy in accordance with paragraphs 10a and 10b(i) of SSAP No. 10, even though the entity may not implement that strategy within the 12 month period. This approach is similar to that outlined in Paragraph 22 of FASB Statement No. 109, Accounting for Income Taxes (FAS 109) that states:

22. In some circumstances, there are actions (including elections for tax purposes) that (a) are prudent and feasible, (b) an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization of deferred tax assets. This Statement refers to those actions as tax-planning strategies. An enterprise shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance.
FAS 109 defines a tax planning strategy as:

An action (including elections for tax purposes) that meets certain criteria (paragraph 22) and that would be implemented to realize a tax benefit for an operating loss or tax credit carryforward before it expires…

INT 01-20 Status

4. During the June 11, 2001, the working group determined that a comprehensive implementation guide for SSAP No. 10 was needed rather than addressing this and several other issues individually. Therefore, further discussion planned at a future meeting.
Interpretation of the Emerging Accounting Issues Working Group

INT 01-22: Use of Interim Financial Statements in Computing Reporting Entity’s Investment in Subsidiary Under the GAAP Equity Method

ISSUE NULLIFIED BY SSAP No. 88

INT 01-22 Dates Discussed

March 26, 2001; June 11, 2001

INT 01-22 References

SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46)

INT 01-22 Issue

1. A reporting entity records its investment in subsidiary utilizing the GAAP equity method. Both the reporting entity and the subsidiary have December 31 year ends; however, the subsidiary’s December 31 financial statements are not completed in time for the reporting entity to use those financial statements to compute its value of its investment in subsidiary. The reporting entity has historically used the subsidiary’s unaudited GAAP September 30 financial statements to compute their ownership at December 31, and the subsidiary’s audited GAAP December 31 financial statements to compute their ownership at March 31, so that the lag in reporting is consistent from period to period.

2. The accounting issue is does the reporting entity need to require that the subsidiary’s September 30 financial statements be audited in order to comply with the requirement in SSAP No. 46, paragraph 7 b. iii?

INT 01-22 Discussion

3. The working group reached a consensus that a reporting entity does not need to require the subsidiary’s interim financial statements to undergo audit. However, the subsidiary’s financial statements must be audited on an annual basis, and any audit adjustments resulting in a change in the reporting entity’s value of its investment in the subsidiary shall be reflected in the reporting entity’s financial statements immediately upon receipt of the audit report. The change shall be included in the reporting entity’s unrealized gain/loss account. Due to the lag in reporting, the reporting entity may continue to use unaudited GAAP financial statements to compute its investment in subsidiary value for its June, September and December statutory financial statements.

INT 01-22 Status

4. No further discussion planned.
INT 01-24: Application of SSAP No. 46 and 48 to Certain Noninsurance Subsidiary, Controlled or Affiliated Entities

ISSUE NULLIFIED BY SSAP No. 88

INT 01-24 Dates Discussed

May 3, 2001; June 11, 2001; October 16, 2001

INT 01-24 References

SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46)
SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48)

INT 01-24 Issue

1. SSAP No. 46 and SSAP No. 48 provide guidance as to the valuation of noninsurance subsidiary, controlled and affiliated (SCA) entities. SSAP No. 46 prescribes the use of either the Statutory Equity Method (as described in paragraph 7.b.ii) or the GAAP Equity Method (as described in paragraph 7.b.iii.) for the valuation of noninsurance SCA investments. SSAP No. 48 directs users to one of the equity methods in SSAP No. 46 for investments in joint ventures, partnerships and limited liability companies, except for limited partnerships with a minor ownership interest. In order to provide further guidance as to the application of SSAP No. 46 and SSAP No. 48, the working group was asked to interpret several specific SCA arrangements.

2. The accounting issue is whether the following SCA arrangements should be valued under the Statutory Equity Method or the GAAP Equity Method?

   Issue 1 - Insurance Company A owns 100% of a third party administrator, TPA1. TPA1 processes claims for noninsurance companies and for Medicare and Medicaid programs. TPA1 does not process claims for Insurance Company A.

   Issue 2 - Insurance Company A owns 100% of a company that processes insurance claims, TPA2. TPA2 processes claims for Insurance Company A, Insurance Company B, Insurance Company C and Insurance Company D. TPA2 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Companies B, C and D are not affiliates of Insurance Company A. The processing of claims for Insurance Company A constitutes 20% of the business (revenues) of TPA2.

   Issue 3 - Insurance Companies A, B, C and D each own 25% of a company, TPA3, that provides administrative services, including all EDP processing, to Insurance Companies A, B, C and D. TPA3 owns the EDP equipment and software and furniture, fixtures and equipment necessary to provide administrative services to its customers. TPA3 does not provide administrative services to any other entities. Insurance Companies A, B, C and D are not part of the same insurance holding company system. The processing that TPA3 does for each of Insurance Companies A, B, C and D constitutes 25% of its business and revenues.

   Issue 4 - Insurance Company A owns 100% of a company, TPA4, that provides administrative services, including EDP processing, to Insurance Company A,
Insurance Company B, Bank C and Manufacturing Company D. TPA4 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D are not affiliates, i.e. none of the four companies are related to one another. The processing that TPA4 does for Insurance Company A represents 40% of TPA4’s business and revenues.

Issue 5 - Insurance Company A owns 100% of a company, TPA5, that provides claims administration services, including EDP processing, to Insurance Company A, Insurance Company B, numerous self-insured companies and Medicare. TPA5 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B and the self-insured companies are not affiliates, i.e. they are not related to one another. Insurance Companies A and B may provide stop-loss coverage to some of the self-insured companies for whom TPA5 provides claims administration services. The processing that TPA5 does for Insurance Company A represents 51% of TPA5’s business and revenues.

Issue 6 - Insurance Company A holds a 18.77% Partnership Interest in LP A. This fund was organized for the primary purpose of investing in investment vehicles and commodity pools as a “fund of funds” investment manager. The insurer is a limited partner. The general partner is not affiliated with the insurer. Quoting from the limited partnership agreement Section 3.1 – “The general partner shall be vested with the complete control of the business of the fund. The limited partners shall have no responsibility for the management of the fund and shall have no authority or right to act on behalf of the fund or to bind the fund in connection with any matter.” The largest holding on their 12/31/99 audited GAAP financials was $293.6 million of “Investments in limited partnerships and investment funds, at fair value.” Beyond that they have $28.0 million of cash and cash equivalents and $90k of dividends and interest receivable.

Issue 7 - Insurance Company A holds a 25% Partnership Interest in LP B. Similar to the LP A above, LP B is another limited partnership investment where the insurer owns greater than a 10% interest. The LP fund was organized primarily for the purpose of making investments in media businesses. The fund’s general partner is not affiliated with the insurer. The general partner manages all of the affairs of the Fund, i.e., controls the business activities of the fund. The largest holding on their 12/31/99 unaudited GAAP financials (assume for this example that audited statements are not and will not be prepared) was $194.0 million of “Portfolio investments at fair value”. This was made up of a combination of partnership and stock investments. Total assets were $200.8 million at 12/31/99.

Issue 8 - Insurance Company A holds a 25% Partnership Interest in LLP C. LLP C is a real estate development limited partnership in which the insurer holds a 25% interest as a limited partner. The LLP’s general partner is not affiliated with the insurer. The general partner manages the affairs of partnership including decisions on properties to acquire and/or develop. Assets of the partnership include real estate properties, both residential and commercial. Total assets of the partnership are $1 billion and total liabilities $500 million, primarily outside debt. LLP C prepares annual audited GAAP financial statements, however, they are not completed prior to the insurer filing its annual financial statements.
INT 01-24 Discussion

3. The working group reached the following:

Issue 1 - The working group reached a consensus that Insurance Company A would value its investment in TPA1 under the GAAP Equity Method.

Issue 2 - The working group was unable to reach a consensus on this issue.

Issue 3 - The working group reached a consensus that Insurance Companies A, B, C and D would value their respective investment in TPA3 under the Statutory Equity Method.

Issue 4 - The working group was unable to reach a consensus on this issue.

Issue 5 - The working group reached a consensus that Insurance Company A would value its investment in TPA5 under the Statutory Equity Method.

Issue 6 - The working group reached a consensus that Insurance Company A would value its investment in LP A under the GAAP Equity Method.

Issue 7 - The working group reached a consensus that Insurance Company A would value its investment in LP B under the GAAP Equity Method. The working group also reached a consensus that Insurance Company A would nonadmit the assets as audited GAAP financials are not available\(^1\).

Issue 8 - The working group reached a consensus that Insurance Company A would value its investment in LLP C under the GAAP Equity Method. INT 01-22 speaks to the timing of the GAAP audits.

INT 01-24 Status

4. No further discussion planned.

\(^1\) The Statutory Accounting Principles Working Group adopted a nonsubstantive modification to SSAP No. 48 to incorporate a grandfathering provision for investments made prior to January 1, 2001 on December 10, 2001.
Interpretation of the Emerging Accounting Issues Working Group

INT 02-07: Definition of Phrase “Other Than Temporary”

ISSUE NULLIFIED BY INT 06-07

INT 02-07 Dates Discussed
March 18, 2002; June 9, 2002; December 5, 2004; March 13, 2005

INT 02-07 References

SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities (SSAP No. 26)
SSAP No. 30—Investments in Common Stock (SSAP No. 30)
SSAP No. 32—Investments in Preferred Stock (SSAP No. 32)
SSAP No. 37—Mortgage Loans (SSAP No. 37)
SSAP No. 39—Reverse Mortgages (SSAP No. 39)
SSAP No. 43R—Loan-backed and Structured Securities (SSAP No. 43R)
SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46)
SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48)
SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68)
SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments (SSAP No. 93)
SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88 (SSAP No. 97)

INT 02-07 Issue

1. The Accounting Practices and Procedures Manual makes reference to an “other than temporary” decline in fair value in 9 different SSAPs. The SSAPs stipulate that if the impairment is judged to be other than temporary, the cost basis of the individual asset shall be written down to a new cost basis and the amount of the write-down shall be accounted for as a realized loss. The SSAPs do not define the phrase “other than temporary.” In applying this guidance to a specific situation, the NAIC Staff was informed that Company A has interpreted “other than temporary” to mean permanent impairment. Therefore, because Company A’s management has not been able to determine that its investment in Company B is permanently impaired, no realized loss has been recognized even though the fair value of B’s shares is currently less than one-third of A’s cost.

2. The accounting issues are:
   a. Should the phrase “other than temporary” be interpreted to mean “permanent?”
   b. Is it appropriate for reporting entities, independent auditors or state examiners to apply predefined thresholds to the phrase “other than temporary”?
   c. When management determines that a write-down, accounted for as a realized loss is necessary, how should the amount of the write-down be determined?
INT 02-07 Discussion

3. On June 9, 2002, the working group reached a consensus position regarding each of the accounting issues as noted below. On March 13, 2005 the working group reached a consensus to update paragraph 5 and insert paragraph 6 as shown in tracked changes below.

4. Question a – No. The working group believes that the NAIC consciously chose the phrase “other than temporary” because it did not intend that the test be “permanent impairment.” The fair value of assets may decline for various reasons. The market price may be affected by general market conditions, which reflect prospects for the economy as a whole, or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment.

5. There are numerous factors to be considered in such an evaluation and their relative significance will vary from case to case. The working group believes that the following are only a few examples of the factors, which, individually or in combination, indicate that a non-interest related decline is other than temporary and that a write-down of the carrying value is required:
   a. The length of time and the extent to which the fair value has been less than cost;
   b. The financial condition and short-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the asset or the discontinuance of a segment of the business that may affect the future earnings potential; or
   c. The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

6. An interest related impairment should be deemed other-than-temporary when an investor has the intent to sell, at the reporting date, an investment before recovery of the cost of the investment. The investor should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that the investment may need to be sold before the forecasted recovery occurs.

7. Unless evidence exists to support the assertion that the decline in fair value below carrying value is temporary, a write-down accounted for as a realized loss should be recorded. In accordance with the guidance of the SSAPs, such loss should be recognized in the determination of net income for the period in which it occurs. The written down value of the investment in the company becomes the new cost basis of the investment.

8. Question b – No. The working group is aware that certain insurers, independent auditors and state examiners, over time, have developed quantitative thresholds as "rules of thumb" to assist in the evaluation of asset impairment. One rule of thumb in particular suggests that if the fair value of the asset is more than 20% less than its cost then it is considered to be other than temporarily impaired. Another suggests that an asset is other than temporarily impaired if the fair value has been less than cost for more than 6 months. The use of a numerical threshold may provide the basis for a preliminary assumption that – without considering all relevant circumstances – an impairment may have occurred. The working group has no objection to such a "rule of thumb" as an initial step in assessing impairment but quantifying the impairment is only the beginning of the analysis; it cannot appropriately be used as a substitute for a full analysis of

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1 The recommendations provided by the working group were developed in part from SEC Staff Accounting Bulletin No. 59—Noncurrent Marketable Equity Securities (SAB 59). As such, readers of this Interpretation should understand that SAB 59 has not been adopted as part of Statutory Accounting Principles as SAB’s are not part of the Statutory Hierarchy (see Preamble).
all relevant qualitative considerations. The use of such thresholds removes the ability of
management to apply its judgment, a concept inherent to the impairment model.

9. Question c – The cost or carrying value of the asset should be written down to reflect its
value in accordance with the relevant SSAP, if an impairment exists. A company's management
should follow the impairment guidance in the SSAP pertaining to that particular asset class while
considering various factors on a case-by-case basis in determining the amount of the realized loss
and/or unrealized loss that needs to be recorded. As the impairment rules did not become
effective until January 1, 2001, entities shall use the asset’s carrying value as of January 1, 2001
when applying the impairment concept upon adoption of Codification.

INT 02-07 Status

10. No further discussion planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 02-18: Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9 d.v. and 9 f.

ISSUE NULLIFIED BY SSAP No. 89

INT 02-18 Dates Discussed

September 10, 2002; December 8, 2002; March 9, 2003

INT 02-18 References

SSAP No. 8—Pensions (SSAP No. 8)

INT 02-18 Issue

1. SSAP No. 8—Pensions (SSAP No. 8) models many of its provisions after FASB Statement No. 87, Employers’ Accounting for Pensions (FAS 87) and FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits (FAS 132). Specifically, the minimum accrued benefit liability that is to be reflected on a reporting entity’s financial statements under FAS guidance must be at least as large as the unfunded Accumulated Benefit Obligation (ABO). If the unfunded ABO is larger than the net amount recognized on the financial statements, then an additional amount must be reflected to bring the accrued benefit liability up to the level of the unfunded ABO. This additional amount may be offset by any existing intangible asset (based on the outstanding unrecognized prior service cost, which includes the unrecognized transition obligation). However, in paragraph 2 of SSAP No. 8, any intangible asset shall be considered a nonadmitted asset. Some interested parties believe this contradicts the concept of deferring or amortizing the incremental liability set up January 1, 2001 as described in paragraph 19 of SSAP No. 8 (see examples, particularly example III). Also, in paragraph 37 of FAS 87, only the amount of the additional minimum liability that is in excess of the intangible asset shall be a reduction of equity (or a liability on the balance sheet). The rules under SSAP No. 8 appear to require a company to recognize the entire additional minimum liability, regardless of the existence of any intangible asset.

2. See examples I, II and III attached which are generated in Disclosure under SSAP No. 8. Examples I and II show disclosure for a qualified plan, while example III shows disclosure for a non-qualified plan (SERP or EXCESS plan). Please note that these examples may occur for either a qualified plan or a non-qualified plan. In these examples, each plan generates an additional minimum liability and uses an intangible asset as an offset to the additional minimum liability. Since paragraph 2 of SSAP No. 8 states that any intangible asset shall be considered a nonadmitted asset, then the entire additional minimum liability would need to be recorded on the balance sheet of the reporting entity. In the view of some interested parties, this treatment contradicts the concept of deferring or amortizing the incremental liability set up January 1, 2001 as described in paragraph 19 of SSAP No. 8 (see examples, particularly example III).

3. In examples I, the (accrued) liability is the “net amount recognized” of ($23,000,000) shown under the “Reconciliation of funded status” section. Under FAS 87, if the accumulated benefit obligation exceeds the fair value of assets, the company may need to recognize more liability than the (accrued) liability on the balance sheet. In the example, the “accrued benefit liability” line of the “Amounts recognized in statements of financial position consist of” section is equal to the unfunded accumulated benefit obligation of ($30,000,000) ($104,000,000 – $134,000,000). However, the “accrued benefit liability” is made up of two parts, the (accrued)
liability plus the additional minimum liability. In this example, the (accrued) liability is ($23,000,000) and the additional minimum liability is ($7,000,000) (($30,000,000) – ($23,000,000)).

4. Under paragraph 37 of FAS 87, an intangible asset is allowed to offset the additional minimum liability of ($7,000,000), which is shown in our example in the “intangible asset” line of the “Amounts recognized in statements of financial position consist of” section. For a reporting entity that does not follow SSAP No. 8, the total (accrued) liability on the balance sheet is ($23,000,000), since the additional minimum liability is entirely offset by the intangible asset. This results in a zero amount in the “accumulated other comprehensive income” line of the “Amounts recognized in statements of financial position consist of” section. For a reporting entity that follows SSAP No. 8, the same ($23,000,000) (accrued) liability is on the balance sheet, but it also includes an additional ($7,000,000) since an intangible asset is categorized as a nonadmitted asset.

5. Example II shows a similar situation. However, here the intangible assets does not entirely offset the additional minimum liability and the company has to recognize ($4,000,000) in “accumulated other comprehensive income” in addition to the ($14,000,000) on the balance sheet. The reporting entity that follows SSAP No. 8 would also have the intangible asset of $27,000,000 categorized as a nonadmitted asset, therefore increasing liabilities by another $27,000,000 up to $45,000,000.

**INT 02-18 Discussion**

6. The working group reached a consensus to require reporting entities to recognize the entire minimum pension liability in the financial statement. Further, any intangible asset offsetting the minimum pension liability shall be nonadmitted and charged to surplus.

7. The working group reached a consensus to allow a reporting entity that utilizes an actuarial valuation as of a date prior to the financial statement date to measure plan assets and obligations, and determines that an additional minimum liability is required to be established in accordance with paragraph 37 of FAS No. 87, and if the reporting entity contributes amounts to the plan to fund that additional minimum liability prior to the financial statement date, such amount funded may be used to reduce the additional minimum liability recognized in the reporting entity’s financial statements.

**INT 02-18 Status**

8. No further discussion is planned.
### XYZ Company Retirement Program
#### Example 1
##### SSAP No. 8 Footnote Disclosure

#### Qualified Pension Benefits

<table>
<thead>
<tr>
<th>Description</th>
<th>2001</th>
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</thead>
<tbody>
<tr>
<td>Projected benefit obligation at beginning of year</td>
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<tr>
<td>Service cost</td>
<td>18,000,000</td>
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<tr>
<td>Participant contributions</td>
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<tr>
<td>Benefit payments</td>
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<tr>
<td>Actuarial losses/(gains)</td>
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<tr>
<td>Plan amendments</td>
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<td>Curtailments</td>
<td>0</td>
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<tr>
<td>Settlements</td>
<td>0</td>
</tr>
<tr>
<td>Special termination benefits</td>
<td>0</td>
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<tr>
<td>Business combinations</td>
<td>0</td>
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<td>Divestitures</td>
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<tr>
<td>Projected benefit obligation at end of year</td>
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<tr>
<td>Accumulated benefit obligation at end of year</td>
<td>$134,000,000</td>
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<tr>
<td>Non-vested projected benefit obligation at end of year</td>
<td>$4,000,000</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
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<tbody>
<tr>
<td>Fair value of plan assets at beginning of year</td>
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<td>Actual return on assets (net of expenses)</td>
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<tr>
<td>Employer contributions</td>
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<tr>
<td>Participant contributions</td>
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<tr>
<td>Benefit payments</td>
<td>(2,000,000)</td>
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<tr>
<td>Settlements</td>
<td>0</td>
</tr>
<tr>
<td>Business combinations</td>
<td>0</td>
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<td>Divestitures</td>
<td>0</td>
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<tr>
<td>Fair value of plan assets at end of year</td>
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#### Reconciliation of funded status

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<tbody>
<tr>
<td>Funded status</td>
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<td>Unrecognized prior service cost</td>
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<tr>
<td>Unrecognized actuarial loss/(gain)</td>
<td>14,000,000</td>
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<tr>
<td>Net amount recognized</td>
<td>($23,000,000)</td>
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</table>

#### Amounts recognized in statements of financial position consist of:

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<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid benefit cost</td>
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<tr>
<td>Accrued benefit liability (includes additional minimum liability)</td>
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<tr>
<td>Intangible asset</td>
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<td>Accumulated other comprehensive income</td>
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<tr>
<td>Net amount recognized</td>
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#### Assumptions as of December 31

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<td>Discount rate</td>
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<tr>
<td>Expected return on assets</td>
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<tr>
<td>Rate of compensation increase</td>
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### XYZ Company Retirement Program

**Example II**

**SSAP No. 8 Footnote Disclosure**

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<th>Qualified Pension Benefits</th>
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<tbody>
<tr>
<td>Change in benefit obligation</td>
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<tr>
<td>Projected benefit obligation at beginning of year</td>
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<td>Service cost</td>
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<td>Benefit payments</td>
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<tr>
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<td>Curtailments</td>
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<td>Settlements</td>
<td>0</td>
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<tr>
<td>Special termination benefits</td>
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<tr>
<td>Business combinations</td>
<td>0</td>
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<td>Divestitures</td>
<td>0</td>
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<tr>
<td>Projected benefit obligation at end of year</td>
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<tr>
<td>Accumulated benefit obligation at end of year</td>
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<td>Non-vested projected benefit obligation at end of year</td>
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<table>
<thead>
<tr>
<th>Change in plan assets</th>
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<tbody>
<tr>
<td>Fair value of plan assets at beginning of year</td>
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<tr>
<td>Actual return on assets (net of expenses)</td>
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<tr>
<td>Employer contributions</td>
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<td>Participant contributions</td>
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<td>Business combinations</td>
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<td>Divestitures</td>
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<td>Fair value of plan assets at end of year</td>
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<th>Reconciliation of funded status</th>
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<td>Funded status</td>
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<td>Unrecognized transition obligation/(asset)</td>
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<td>Unrecognized prior service cost</td>
<td>0</td>
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<tr>
<td>Unrecognized actuarial loss/(gain)</td>
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<tr>
<td>Net amount recognized</td>
<td>($14,000,000)</td>
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</table>

<table>
<thead>
<tr>
<th>Amounts recognized in statements of financial position consist of:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid benefit cost</td>
<td>$0</td>
</tr>
<tr>
<td>Accrued benefit liability (includes additional minimum liability)</td>
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<tr>
<td>Intangible asset</td>
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<tr>
<td>Accumulated other comprehensive income</td>
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<tr>
<td>Net amount recognized</td>
<td>($14,000,000)</td>
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</table>

<table>
<thead>
<tr>
<th>Assumptions as of December 31</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount rate</td>
<td>7.25%</td>
</tr>
<tr>
<td>Expected return on assets</td>
<td>9.00%</td>
</tr>
<tr>
<td>Rate of compensation increase</td>
<td>Graded; 3.00% - 6.50%</td>
</tr>
</tbody>
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### XYZ Company Retirement Program
#### Example III
#### SSAP No. 8 Footnote Disclosure

#### Non-Qualified Pension Benefits

<table>
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<tr>
<th>Description</th>
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<tr>
<td>Interest cost</td>
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<tr>
<td>Participant contributions</td>
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<tr>
<td>Benefit payments</td>
<td>0</td>
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<tr>
<td>Actuarial losses/(gains)</td>
<td>1,000,000</td>
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<tr>
<td>Plan amendments</td>
<td>0</td>
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<tr>
<td>Curtailments</td>
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</tr>
<tr>
<td>Settlements</td>
<td>0</td>
</tr>
<tr>
<td>Special termination benefits</td>
<td>0</td>
</tr>
<tr>
<td>Business combinations</td>
<td>0</td>
</tr>
<tr>
<td>Divestitures</td>
<td>0</td>
</tr>
<tr>
<td>Projected benefit obligation at end of year</td>
<td>$12,000,000</td>
</tr>
<tr>
<td>Accumulated benefit obligation at end of year</td>
<td>$11,000,000</td>
</tr>
<tr>
<td>Non-vested projected benefit obligation at end of year</td>
<td>$0</td>
</tr>
</tbody>
</table>

#### Change in plan assets

<table>
<thead>
<tr>
<th>Description</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of plan assets at beginning of year</td>
<td>$0</td>
</tr>
<tr>
<td>Actual return on assets (net of expenses)</td>
<td>0</td>
</tr>
<tr>
<td>Employer contributions</td>
<td>0</td>
</tr>
<tr>
<td>Participant contributions</td>
<td>0</td>
</tr>
<tr>
<td>Benefit payments</td>
<td>0</td>
</tr>
<tr>
<td>Settlements</td>
<td>0</td>
</tr>
<tr>
<td>Business combinations</td>
<td>0</td>
</tr>
<tr>
<td>Divestitures</td>
<td>0</td>
</tr>
<tr>
<td>Fair value of plan assets at end of year</td>
<td>$0</td>
</tr>
</tbody>
</table>

#### Reconciliation of funded status

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funded status</td>
<td>($12,000,000)</td>
</tr>
<tr>
<td>Unrecognized transition obligation/(asset)</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Unrecognized prior service cost</td>
<td>0</td>
</tr>
<tr>
<td>Unrecognized actuarial loss/(gain)</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Net amount recognized</td>
<td>($4,000,000)</td>
</tr>
</tbody>
</table>

Amounts recognized in statements of financial position consist of:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid benefit cost</td>
<td>$0</td>
</tr>
<tr>
<td>Accrued benefit liability (includes additional minimum liability)</td>
<td>($11,000,000)</td>
</tr>
<tr>
<td>Intangible asset</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
<td>0</td>
</tr>
<tr>
<td>Net amount recognized</td>
<td>($4,000,000)</td>
</tr>
</tbody>
</table>

#### Assumptions as of December 31

<table>
<thead>
<tr>
<th>Description</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount rate</td>
<td>7.25%</td>
</tr>
<tr>
<td>Expected return on assets</td>
<td>9.00%</td>
</tr>
<tr>
<td>Rate of compensation increase</td>
<td>Graded; 3.00% - 6.50%</td>
</tr>
</tbody>
</table>
Interpretation of the Emerging Accounting Issues Working Group

INT 02-20: Due Date for Installment Premiums Under an Agency Relationship

ISSUE NULLIFIED BY NONSUBSTANTIVE REVISIONS TO SSAP NO. 6 ADOPTED BY THE STATUTORY ACCOUNTING PRINCIPLES WORKING GROUP

INT 02-20 Dates Discussed

September 10, 2002; December 8, 2002

INT 02-20 References

SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

INT 02-20 Issue

1. Paragraph 7 c. of SSAP No. 6 states that the determination of the due date for installment premium is governed by the contractual due date of the installment. Certain reporting entities with installment premium balances due from an agent have interpreted this guidance to require that the due date of the installment is governed by the contractual due date of the installment from the agent.

2. The accounting issue is whether the due date for installment premiums from an agent is governed by the contractual due date of the installment from the agent or by the due date from the insured.

INT 02-20 Discussion

3. Paragraph 7 a. of SSAP No. 6 states that the due date for original and deposit premiums is governed by the effective date of the underlying contract and not the agent/reporting entity contractual relationship. There is no overriding reason why installment premiums would be treated in a less conservative fashion than original and deposit premiums. Therefore, the due date for installment premium balances due from an agent should be governed by the contractual due date of said premiums from the insured.

INT 02-20 Status

4. No further discussion is planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 03-01: Application of SSAP No. 35 to the Florida Hurricane Catastrophe Fund

ISSUE NULLIFIED DUE TO FLORIDA LEGISLATIVE CHANGES. SEE SSAP NO. 35 FOR GUIDANCE.

INT 03-01 Dates Discussed
March 9, 2003; June 22, 2003; March 5, 2006

INT 03-01 References
SSAP No. 35—Guaranty Fund and Other Assessments (SSAP No. 35)

INT 03-01 Issue

1. Balance-sheet treatment of assessments to property and casualty companies by the Florida Hurricane Catastrophe Fund (“FHCF”) is governed by SSAP No. 35—Guaranty Fund and Other Assessments (SSAP No. 35). This request for interpretation or interim guidance seeks recognition of a gross asset and limitation, given certain conditions, of the assessment liability required by SSAP No. 35.

2. The FHCF is a practical measure imposed by government to mitigate the financial shock attendant on the occurrence or prospect of extreme weather in developed areas with dense population. Risks from hurricanes faced by residential property insurers are clear and present; the necessity to maintain insurance capacity to cover the consequences of hurricanes is the object of the FHCF, which pays residential policyholders’ hurricane-related claims through reinsurance provided to primary companies. Depending on the severity of the weather catastrophe, the FHCF is empowered to issue debt in the form of revenue bonds for payment of residential property-casualty claims in Florida.

3. Such debt issuance in the wake of a hurricane will result in assessments for service of that debt over long periods of time to most primary property and casualty companies doing business in Florida. (Premium revenue from virtually all lines, save for workers’ compensation, is subject to the assessment.) The aggregate magnitude of FHCF assessments to subject companies is dependent on a number of variables, most prominent among which are the extent of damage caused by the weather event, the amount of capital on hand, and costs of debt and its issuance. Assessments to individual companies will be levied as a percentage of their premium in the year prior to assessment. Companies that have exited the Florida market are no longer subject to FHCF assessment and companies entering the Florida market after the event are subject to the assessment.

4. The accounting issues are:

   Issue 1: The nature of FHCF debt and allocation of the consequent debt service, which are the principal drivers of FHCF assessments.

   Issue 2: The absence of treatment of the revenue received by subject companies that elect to recover the assessment in a rate filing.
5. With respect to issue one, FHCF revenue bonds are likely to be issued in decades-long maturities. Allocation of that debt service to individual companies is dependent on those companies’ status in, or share of, the Florida property-casualty market.

6. With respect to issue 2, conditions of Paragraph 10 of SSAP No. 35 do not appear to contemplate the “deemed-approved” election or surcharge available to subject insurers for rate elements to cover the amount of FHCF assessments made to those subject insurers. Although such rate elements can be and are separately identified on many insurers’ premium billings, insurers subject to the FHCF are themselves liable for assessments rather than being collectors and remitters of assessment amounts. Balance-sheet presentation of a liability for FHCF assessments, in the event of their declaration, would appear to be required, therefore, if SSAP No. 35 is applicable.

7. Further, with respect to issue 2, collections by subject insurers would yield revenue, perhaps diminished by some proportion of uncollectibles, as an admitted asset. Because of the nature of the relationship between the subject insurer and the FHCF, SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64) would appear to preclude netting of such cash against FHCF assessments. It is crucial to note, however, that SSAP No. 35, Paragraph 9 admits, in the presence of policy surcharges, the possibility of an admitted asset existing in relation to assessments “paid before premium tax credits are realized or policy surcharges are collected . . . .”

8. SSAP No. 5—Liabilities, Contingencies and Impairments of Assets, and SSAP No. 35, Paragraph 4., draw attention to the future period within which the reporting entity may be able to reliably estimate the amount of FHCF assessments for recognition as a liability. This Interpretation identifies the major variables for calculation of the aggregate amount of the FHCF assessment: amount of damages, capital on hand, costs of debt and issuance. In addition to these variables, and necessary for allocating that aggregate assessment to individual subject companies, is the individual company’s share of the market. That is, both the total market and the individual subject company’s share of the market, both clearly subject to change, are used in allocation of the aggregate amount of the assessment. It is these latter factors, crucial in determining the FHCF assessment to a subject entity, which preclude reliable estimation of FHCF assessments beyond the near future.

9. In practice, the time horizon of subject insurers’ business plans and the dynamics of the property and casualty market suggest strongly that the amount of yearly FHCF assessments to a subject entity may be reliably or reasonably estimated through three years in the future but that such reliability diminishes with greater prospect. Unless management has reason and information to support reliable estimation through a future period longer than three years, it is reasonable to presume that quantification of a liability for FHCF assessments should extend through no less than three years in the future.

INT 03-01 Discussion

10. The working group reached a consensus as follows:

   a) Assessments made by the FHCF are presumed to be reasonably estimable through no less than three years in the future;

   b) An asset shall be allowed for deemed-approved rate elements or surcharges that have been imposed by the reporting entity and filed with the regulator and that are specifically intended to match the period stated within a., to recoup FHCF assessments, which asset shall be reduced by amounts not expected to be collected by the reporting entity; and
c) Disclosure is made of the remaining term of the assessment.

**INT 03-01 Status**

11. No further discussion is planned.
Interpretation of the Emerging Accounting Issues Working Group

INT 04-18: EITF 00-21: Revenue Arrangements with Multiple Deliverables

ISSUE NULLIFIED BY ASU 2009-13, WHICH WAS REJECTED IN MARCH 2010 AS NOT APPLICABLE TO STATUTORY ACCOUNTING

INT 04-18 Dates Discussed

December 5, 2004; March 13, 2005

INT 04-18 References

SSAP No. 22—Leases (SSAP No. 22)
SSAP No. 40—Real Estate Investments (SSAP No. 40)
SSAP No. 77—Real Estate Sales – An Amendment to SSAP No. 40, Real Estate Investments (SSAP No. 77)
SSAP No. 81—Software Revenue Recognition (SSAP No. 81)

INT 04-18 Issue

1. EITF No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21) discusses how to account for arrangements under which the company will perform multiple revenue-generating activities. Specifically, this Issue addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. Integral to this Issue is the concept that separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting. This concept can be overcome if there is sufficient evidence to the contrary. In addition, this Issue discusses how to measure and allocate arrangement consideration to the separate units of accounting. NAIC staff noted that this Issue does not discuss when the criteria for appropriate revenue recognition are met or provide guidance on the appropriate revenue recognition principles.

2. EITF 02-21 contains a useful decision diagram, which is included as Exhibit A. Per EITF 00-21, the applicability of this item to leases, software arrangements and sales of real estate as well as a listing of all Issues are as follows:

4. This Issue applies to all deliverables (that is, products, services, or rights to use assets) within contractually binding arrangements (whether written, oral, or implied, and hereinafter referred to as "arrangements") in all industries under which a vendor will perform multiple revenue-generating activities, except as follows:

   a. A multiple-deliverable arrangement or a deliverable(s) in a multiple-deliverable arrangement may be within the scope of higher-level authoritative literature.¹ That higher-level authoritative literature (including, but not limited to, Statements 13, 45, and 66; Interpretation 45; Technical Bulletin 90-1; and SOPs 81-1, 97-2, and 00-2) (referred to hereinafter as "higher-level literature") may provide guidance with respect to whether and/or how to allocate consideration of a multiple-deliverable arrangement. The following describes the three categories

¹Whether a deliverable(s) is within the scope of higher-level authoritative literature is determined by the scope provisions of that literature, without regard to the order of delivery of that item in the arrangement. The term higher-level literature refers to items captured within the FASB Accounting Standards Codification.
into which that higher-level literature falls and the application of this Issue or the higher-level literature in determining separate units of accounting and allocating arrangement consideration:

i. If higher-level literature provides guidance regarding the determination of separate units of accounting and how to allocate arrangement consideration to those separate units of accounting, the arrangement or the deliverable(s) in the arrangement that is within the scope of that higher-level literature should be accounted for in accordance with the relevant provisions of that literature rather than the guidance in this Issue.

ii. If higher-level literature provides guidance requiring separation of deliverables within the scope of higher-level literature from deliverables not within the scope of higher-level literature, but does not specify how to allocate arrangement consideration to each separate unit of accounting, such allocation should be performed on a relative fair value basis using the entity's best estimate of the fair value of the deliverable(s) within the scope of higher-level literature and the deliverable(s) not within the scope of higher-level literature. Subsequent accounting (identification of separate units of accounting and allocation of value thereto) for the value allocated to the deliverable(s) not subject to higher-level literature would be governed by the provisions of this Issue.

iii. If higher-level literature provides no guidance regarding the separation of the deliverables within the scope of higher-level literature from those deliverables that are not or the allocation of arrangement consideration to deliverables within the scope of the higher-level literature and to those that are not, then the guidance in this Issue should be followed for purposes of such separation and allocation.

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2 Solely for purposes of the allocation between deliverables within the scope of higher-level literature and deliverables not within the scope of higher-level literature, an entity's best estimate of fair value is not limited to vendor-specific objective evidence of fair value or third-party evidence of fair value, as those concepts are discussed in paragraph 16 of this Issue.

3 For example, leased assets are required to be accounted for separately under the guidance of Statement 13. Consider an arrangement that includes the lease of equipment under an operating lease, the maintenance of the leased equipment throughout the lease term (executory cost), and the sale of additional equipment unrelated to the leased equipment. The arrangement consideration should be allocated between the Statement 13 deliverables and the non-Statement 13 deliverables on a relative fair value basis using the entity's best estimate of fair value of the Statement 13 and non-Statement 13 deliverables. (Although Statement 13 does not provide guidance regarding the accounting for executory costs, it does provide guidance regarding the allocation of arrangement consideration between the lease and the executory cost elements of an arrangement. Therefore, this example refers to the leased equipment and the related maintenance as Statement 13 deliverables.) The guidance in Statement 13 would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. This Issue would be applied to further separate any non-Statement 13 deliverables and to allocate the related arrangement consideration.

4 For example, SOP 81-1 provides separation and allocation guidance (segmentation provisions) for deliverables within its scope. However, SOP 81-1 does not provide separation and allocation guidance between SOP 81-1 deliverables and non-SOP 81-1 deliverables. Consider an arrangement that includes designing complex electronic equipment, manufacturing complex electronic equipment (both SOP 81-1 deliverables), and providing the service of running the equipment for a fixed period of time once the equipment is designed, manufactured, and placed in service (a non-SOP 81-1 deliverable). This Issue would be applied to identify separate units of accounting and to allocate arrangement consideration to those separate units of accounting. If applying the guidance in this Issue results in the separation of the design and manufacture of the equipment from the service of running the equipment, the segmentation provisions of SOP 81-1 would be used to determine if it is appropriate to further segment the design deliverables from the manufacture deliverables in accordance with its segmentation provisions. If this Issue prohibits separation of the SOP 81-1 deliverables from the non-SOP 81-1 deliverables, then the amounts otherwise allocable to the design and manufacture deliverables and to the service of running the equipment should be
circumstances, it is possible that a deliverable subject to the guidance of higher-level literature does not meet the criteria in paragraph 9 of this Issue to be considered a separate unit of accounting. In that event, the arrangement consideration allocable to such deliverable should be combined with the amount allocable to the other applicable undelivered item(s) within the arrangement. The appropriate recognition of revenue should then be determined for those combined deliverables as a single unit of accounting.

b. Arrangements that include vendor offers to a customer for either (1) free or discounted products or services that will be delivered (either by the vendor or by another unrelated entity) at a future date if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period or (2) a rebate or refund of a determinable cash amount if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period, are excluded from the scope of this Issue. Additionally, arrangements involving the sale of award credits by broad-based loyalty program operators are excluded from the scope of this Issue.

5. The issues are:

Issue 1—How to determine whether an arrangement with multiple deliverables consists of more than one unit of accounting

Issue 2—If an arrangement consists of more than one unit of accounting, how the arrangement consideration should be allocated among the separate units of accounting

Issue 3—What effect, if any, certain customer rights due to vendor nonperformance have on the measurement of arrangement consideration and/or the allocation of consideration to the delivered unit(s) of accounting

Issue 4—How to account for direct costs incurred related to an arrangement that (a) are not associated with a specific deliverable or (b) are associated with a specific deliverable but that deliverable is required to be combined with another deliverable (or other deliverables)

Issue 5(a)—The impact, if any, of a customer's ability to cancel a contract and incur a cancellation penalty on the measurement of arrangement consideration

Issue 5(b)—The impact, if any, of consideration that varies as a result of future customer actions on the measurement and/or allocation of arrangement consideration

Issue 5(c)—The impact, if any, of consideration that varies as a result of future vendor actions on the measurement and/or allocation of arrangement consideration

Issue 6—The impact of a vendor's intent not to enforce its contractual rights in the event of customer cancellation on the measurement and/or allocation of arrangement consideration.

INT 04-18 Discussion

3. Per EITF 00-21:

6. In an arrangement with multiple deliverables, the Task Force reached a consensus that the principles in paragraph 7 and application guidance in paragraphs 8–17 should be used to determine (a) how the arrangement consideration should be measured, (b) whether the arrangement should be divided into separate units of accounting, and (c) how the arrangement consideration should be allocated among the separate units of accounting. …
INT 04-18  Superseded SSAPs and Nullified Interpretations

Principles
7. The principles applicable to this Issue are:

• Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet the criteria in paragraph 9.

• Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values (or as otherwise provided in paragraph 12). The amount allocated to the delivered item(s) is limited as discussed in paragraph 14.

• Applicable revenue recognition criteria should be considered separately for separate units of accounting.

Application Guidance
Units of Accounting (Issue 1)
8. A vendor should evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting. That evaluation must be performed at the inception of the arrangement and as each item in the arrangement is delivered.

9. In an arrangement with multiple deliverables, the delivered item(s) should be considered a separate unit of accounting if all of the following criteria are met:

a. The delivered item(s) has value to the customer on a standalone basis. That item(s) has value on a standalone basis if it is sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis.

In the context of a customer's ability to resell the delivered item(s), the Task Force observed that this criterion does not require the existence of an observable market for that deliverable(s).

b. There is objective and reliable evidence of the fair value of the undelivered item(s).

c. If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

Refer to the flowchart in Exhibit 00-21A for an illustration of the above criteria. The criteria for dividing an arrangement into separate units of accounting should be applied consistently to arrangements with similar characteristics and in similar circumstances.

10. The arrangement consideration allocable to a delivered item(s) that does not qualify as a separate unit of accounting within the arrangement should be combined with the amount allocable to the other applicable undelivered item(s) within the arrangement. The appropriate recognition of revenue should then be determined for those combined deliverables as a single unit of accounting.

Measurement and Allocation of Arrangement Consideration (Issues 2, 3, 5(a), 5(b), 5(c), and 6)
11. The amount of total arrangement consideration must be fixed or determinable other than with respect to the impact of (a) any refund rights or other concessions (hereinafter collectively referred to as "refund rights") to which the customer may be entitled or (b) performance bonuses to which the vendor may be entitled.

12. If there is objective and reliable evidence of fair value (as discussed in paragraph 16) for all units of accounting in an arrangement, the arrangement consideration should be allocated to the separate units of accounting based on their relative fair values (the relative fair value method), except as specified in paragraph 13. However, there may be cases in which there is objective and reliable evidence of the fair value(s) of the undelivered item(s) in an arrangement but no such evidence for the delivered item(s). In those cases, the residual method should be used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered item(s) equals the total arrangement consideration less the aggregate fair value of the undelivered item(s). The "reverse" residual method (that is, using a residual
method to determine the fair value of an undelivered item) is not an acceptable method of allocating arrangement consideration to the separate units of accounting, except as described in paragraph 13.

13. To the extent that any separate unit of accounting in the arrangement (including a delivered item) is required under GAAP to be recorded at fair value (and marked to market each reporting period thereafter), the amount allocated to that unit of accounting should be its fair value. Under those circumstances, the remainder of arrangement consideration should be allocated to the other units of accounting in accordance with the requirements in paragraph 12.

14. The amount allocable to a delivered item(s) is limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions (the non-contingent amount). That is, the amount allocable to the delivered item(s) is the lesser of the amount otherwise allocable in accordance with paragraphs 12 and 13, above, or the non-contingent amount.

15. The Task Force reached a consensus that the measurement of revenue per period should be limited to the measurement that results from assuming that cancellation of the arrangement will not occur. The Task Force observed that the amount recorded as an asset for the excess of revenue recognized under the arrangement over the amount of cash or other consideration received from the customer since the inception of the arrangement should not exceed all amounts to which the vendor is legally entitled, including cancellation fees (in the event of customer cancellation). However, the Task Force further observed that whether a vendor intends to enforce its contractual rights in the event of customer cancellation should be considered in determining the extent to which an asset should be recorded.

16. Contractually stated prices for individual products and/or services in an arrangement with multiple deliverables should not be presumed to be representative of fair value. The best evidence of fair value is the price of a deliverable when it is regularly sold on a standalone basis. Fair value evidence often consists of entity-specific or vendor-specific objective evidence (VSOE) of fair value. As discussed in paragraph 10 of SOP 97-2, VSOE of fair value is limited to (a) the price charged for a deliverable when it is sold separately or (b), for a deliverable not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not change before the separate introduction of the deliverable into the marketplace). The use of VSOE of fair value is preferable in all circumstances in which it is available. Third-party evidence of fair value (for example, prices of the vendor's or any competitor's largely interchangeable products or services in sales to similarly situated customers) is acceptable if VSOE of fair value is not available.

Accounting for Direct Costs in an Arrangement with Multiple Deliverables (Issue 4)

17. The Task Force agreed not to provide guidance on Issue 4 due to the broad, general nature of the question and its applicability beyond arrangements involving multiple deliverables. As such, this Issue does not address the allocation of direct costs in an arrangement.

Disclosure

18. A vendor should disclose (a) its accounting policy for recognition of revenue from multiple-deliverable arrangements (for example, whether deliverables are separable into units of accounting) and (b) the description and nature of such arrangements, including performance-, cancellation-, termination-, or refund-type provisions.

4. The working group noted that that even though higher-level literature exists in statutory accounting, some multiple deliverable arrangements may exist or may be created that are outside the scope of existing guidance. Thus, the Emerging Accounting Issues Working Group reached a consensus to adopt the conclusions reached in EITF 00-21 for non-insurance related activities only as an interpretation of SSAP No. 22, SSAP No. 40, SSAP No. 77 and SSAP No. 81 with modification to change all GAAP references to those applicable to statutory accounting as follows:
a. Change references from FASB Statement No. 13, *Accounting for Leases* (Statement 13) to SSAP No. 22;

b. Change references from FASB Statement No. 66, *Accounting for Sales of Real Estate* (Statement 66) to SSAP No. 40 and SSAP No. 77;

c. Change references from AICPA SOP 97-2, *Software Revenue Recognition* (SOP 97-2) to SSAP No. 81;

d. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (Interpretation 45) has not been reviewed for applicability to statutory accounting as of the date of INT 04-18; and

e. References to FASB Statement No. 45, *Accounting for Franchise Fee Revenue* (Statement 45); FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* (Technical Bulletin 90-1); AICPA SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1) and AICPA SOP 00-2, *Accounting by Producers or Distributors of Films* (SOP 00-2) are not applicable to statutory accounting.

**INT 04-18 Status**

5. No further discussion is planned.
Determining Separate Units of Accounting

Arrangement has multiple deliverables and is within the scope of Issue 00-21.

Does the delivered item(s) have standalone value to the customer?

Yes

Is there objective and reliable evidence of the fair value of the undelivered item(s)?

No

Do not account for delivered item(s) as a separate unit of accounting.

Yes

If the arrangement includes a general right of return relative to the delivered item(s), is delivery of the undelivered item(s) probable and substantially controlled by the vendor?

No

Account for delivered item(s) as a separate unit of accounting.

Yes or N/A

Issue No. 00-21 Footnote 5—This diagram represents an overview of the provisions of this Issue with respect to determining the separate units of accounting in an arrangement and should; therefore, be reviewed in conjunction with the entire consensus.
Interpretation of the Emerging Accounting Issues Working Group

INT 09-04: Application of the Fair Value Definition

ISSUE NULLIFIED BY SSAP No. 100

INT 09-04 Dates Discussed

March 26, 2009; April 7, 2009; April 16, 2009; June 13, 2009

INT 09-04 References

Fair Value Definition in the Glossary to the Accounting Practices and Procedures Manual

INT 09-04 Issue

1. The accounting issue is application of the current definition of “fair value” within the Glossary to the Statutory Accounting Principles in situations when the volume and level or activity for the asset or liability have significantly decreased and to transactions which are forced or liquidation sales.

INT 09-04 Discussion

2. The working group reached a consensus that the following guidance shall be followed in determining fair value when the volume and level or activity for the asset or liability have significantly decreased and to transactions which are forced or liquidation sales:

3. Consistent with the current fair value definition, a quoted market price in an active market is the best evidence of fair value and shall be used as the basis of measurements when an active market exists.

4. Even if there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation techniques used, the objective of the fair value definition remains the same:

   The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

5. Markets where the volume and level of activity for the asset or liability have significantly decreased do not require use of quoted prices as representations of fair value. Although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis. The estimate of fair value under such market conditions shall be based on the best information available as described in the definition of “fair value” within the Glossary to the Accounting Practices and Procedures Manual. Consistent with the Glossary, in determining the best information available, consideration must be given to the assumptions that market participants would use in the estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment and volatility. If estimates of expected future cash flows are used to estimate fair value, such information shall be the best estimate on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent the evidence can be verified objectively.
6. Each reporting entity shall use its judgment in determining whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability. This list of example factors is not considered all-inclusive, and any or all of these factors could provide the evidence necessary to determine whether a decrease in the volume and level of activity has occurred:

   a. There are few recent transactions.

   b. Price quotations are not based on current information.

   c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).

   d. Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

   e. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity’s estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.

   f. There is a wide bid-ask spread or significant increase in the bid-ask spread.

   g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.

   h. Little information is released publicly (for example, a principal-to-principal market).

7. If the reporting entity concludes that there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are a result of a forced or liquidation sale). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale.)

8. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique.). When weighing indications of fair value resulting from the use of multiple valuation techniques, a reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

9. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, a reporting entity’s intention to hold or
10. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are part of a forced or liquidation sale. Circumstances that may indicate that a transaction was part of a forced or liquidation sale:

   a. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

   b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

   c. The seller is in or near bankruptcy or receivership (that is, liquidation), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).

   d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

A reporting entity shall evaluate the circumstances to determine whether the transaction is or is not part of a forced or liquidation sale based on the weight of the evidence.

11. The determination of whether a transaction is part of a forced or liquidation sale is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. Accordingly, the reporting entity shall consider the following guidance:

   a. If the weight of the evidence indicates the transaction is part of a forced or liquidation sale, a reporting entity shall place little, if any, weight on that transaction price when estimating fair value or market risk premiums.

   b. If the weight of the evidence indicates that the transaction is not part of a forced or liquidation sale, a reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.

   c. If the reporting entity does not have sufficient information to conclude that the transaction is not part of a forced or liquidation sale, it shall consider that transaction price when estimating fair value or market risk premiums. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). A reporting entity shall place less weight on transactions on which a reporting entity does not have sufficient information to conclude whether the transaction is part of a forced or liquidation sale when compared with other transactions that are known not to be part of a forced or liquidation sale.
12. In its determinations, a reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. A reporting entity would be expected to have sufficient information to conclude whether a transaction is part of a forced or liquidation sale when it is party to the transaction.

13. Regardless of the valuation techniques used, a reporting entity shall include appropriate risk adjustments. A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a “risk adjustment”. Risk premiums should be reflective of a transaction, other than a forced or liquidation sale, between market participants at the measurement date under current market conditions.

14. When estimating fair value, the fair value definition does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when a reporting entity has determined that the quoted prices provided by those parties are determined pursuant to the fair value definition. However, when there has been a significant decrease in the volume or level of activity for the asset or liability, a reporting entity shall evaluate whether those quoted prices are based on current information that does not reflect forced or liquidation sales or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighing a quoted price as an input to a fair value measurement, a reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence, with more weight given to quotes based on binding offers.

15. This consensus has an effective date for interim and annual financial reporting periods ending on or after June 30, 2009. The effective date is restricted to prospective application and prohibits retrospective application to a prior interim or annual reporting period.

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16. No further discussion planned.
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